CLERK'S COPY.

TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1941

No. 503

PALM SPRINGS HOLDING CORPORATION,
PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR CERTIORARI FILED AUGUST 11, 1941.

CERTIORARI GRANTED OCTOBER 13, 1941.

No. 9661

United States

Circuit Court of Appeals

For the Ninth Circuit.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

PALM SPRINGS HOLDING CORPORATION,
Respondent,

and

PALM SPRINGS HOLDING CORPORATION,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of the Record

Upon Petition to Review a Decision of the United States Board of Tax Appeals.

INDEX

[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

	Page
Answer	20
Appearances	1
Assignments of Error (filed by Commissioner)	40
Assignments of Error (filed by Taxpayer)	51
Certificate	68
Decision	35
Designation of Portions of Record, Proceedings, and Evidence contained in Record filed by Commissioner	62
Designation of Portions of Record, Proceedings, and Evidence contained in Record filed by Taxpayer	64
Designation of Portions of the Record to be Printed filed by General Counsel	60
Designation of Portions of the Record to be Printed filed by Taxpayer	61
Docket Entries	1
Findings of Fact	22
Memorandum Findings of Fact and Opinion	22
Notices of Filing Petitions for Review	43, 44, 54

Index

	Page
Opinion	30
Order from 9th Circuit re Consolidation of Records	67
Petition	4
Petition for Review filed by Commissioner	36
Petition for Review filed by Taxpayer	46
Review:	
Assignments of Error (filed by Commissioner)	40
Assignments of Error (filed by Taxpayer)	51
Designation of Contents of Record on (filed by Commissioner)	60, 62
Designation of Contents of Record on (filed by Taxpayer)	61, 64
Petition for (filed by Commissioner)	36
Petition for (filed by Taxpayer)	46
Statement of Points on (filed by Commissioner)	55
Statement of Points on (filed by Taxpayer)	58
Statement of Points filed by Commissioner	55
Statement of Points filed by Taxpayer	58

Index

Page

Stipulation of Facts 22

Exhibits to Stipulation of Facts:

A—Agreement under which Palm Springs Hotel Co. first mortgage seven percent sinking fund gold bonds were deposited with bondholders protective committee 70

B—Certificate of preferred stock of Palm Springs Holding Corporation 74

C—Certificate of common stock of Palm Springs Holding Corporation 76

D—Letter dated March 3, 1932 from the Bondholders' Protective Committee setting forth plan of reorganization 81

Proceedings in U. S. C. C. A., Ninth Circuit 85

Order of submission 87

Order directing filing of opinion and judgment 87

Opinion, Mathews, J. 88

Judgment 96

Clerk's certificate 97

Order allowing certiorari 98

Docket No. 95262

APPEARANCES:

For Taxpayer:
FRANK MERGENTHALER, Esq.

For Comm'r:
E. A. TONJES, Esq.,
FRANK T. HORNER, Esq.,
E. M. WOOLF, Esq.

PALM SPRINGS HOLDING CORPORATION,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DOCKET ENTRIES

1938

Aug. 29—Petition received and filed. Taxpayer notified. (Fee paid).

Aug. 29—Copy of petition served on General Counsel.

Aug. 29—Request for circuit hearing in Los Angeles, California, filed by taxpayer. 8/29/38 copy served.

Oct. 13—Answer filed by General Counsel.

Oct. 15—Copy of answer served on taxpayer. Los Angeles, Calif.

1939

July 11—Hearing set Sept. 18, 1939, Los Angeles, California.

1939

Sept. 27—Hearing had before Mr. Kern on the merits. Submitted. Stipulation of facts filed. Briefs due Dec. 1, 1939. Reply briefs due Dec. 26, 1939.

Oct. 23—Transcript of hearing of 9/27/39 filed.

Nov. 29—Brief filed by taxpayer. 12/2/39 copy served on General Counsel.

Dec. 1—Brief filed by General Counsel.

Dec. 23—Reply brief filed by taxpayer.

1940.

Mar. 23—Memorandum findings of fact and opinion rendered, John W. Kern, Div. 16. Decision will be entered under Rule 50.

Apr. 16—Computation of deficiency filed by General Counsel.

Apr. 18—Hearing set May 22, 1940 on settlement.

May 22—Hearing had before Mr. Arundell on settlement under Rule 50. Respondent's recomputation not contested. Referred to Mr. Kern for decision.

May 25—Decision entered, John W. Kern, Div. 16.

Aug. 10—Petition for review by United States Circuit Court of Appeals, Ninth Circuit; with assignments of error filed by General Counsel.

Aug. 20—Proof of service filed by General Counsel. (2)

Aug. 22—Statement of points filed by General Counsel, with proof of service thereon.

1940

Aug. 22—Agreed designation of portions of the record to be printed, filed by General Counsel.

Aug. 22—Agreed designation of portions of record filed (General Counsel), with proof of service thereon. [1*]

Aug. 22—Petition for review by United States Circuit Court of Appeals, Ninth Circuit, with assignments of error filed by taxpayer.

Aug. 22—Proof of service filed by taxpayer.

Sept. 5—Statement of points filed by taxpayer, with proof of service thereon.

Sept. 5—Agreed designation of portions of the record to be printed filed by taxpayer.

Sept. 5—Agreed designations of portions of record filed by taxpayer, with proof of service thereon.

Sept. 16—Certified copy of order from the 9th Circuit that the proceedings be consolidated for briefing, hearing, argument and decision upon a single consolidated transcript of record, consisting of such portions of the record made before the United States Board of Tax Appeals as the parties herein may indicate by their designations, omitting any repetition of documents, filed.

Sept. 16—Certified copy of order from the 9th Circuit extending the time to Oct. 19, 1940 to transmit the record, filed. [2]

*Page numbering appearing at foot of page of original certified Transcript of Record.

United States Board of Tax Appeals

Docket No. 95262

PALM SPRINGS HOLDING CORPORATION,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

PETITION

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue, in his Notice of Deficiency (IT:LA, FHG-90D) dated June 1, 1938, and as a basis of this proceeding, alleges as follows:—

1st. That the petitioner is a corporation, organized and existing under the laws of the State of California, with its principal office at the El Mirador Hotel, Palm Springs, California.

2nd. That the petitioner filed its Federal Income and Excess-Profits Tax Return for the fiscal year ended May 31, 1936, with the Collector of Internal Revenue for the Sixth District of California.

3rd. A Notice of Deficiency, a copy of which is attached and marked "Exhibit A", was presumably [3] mailed to the petitioner on Jupe 1, 1938.

4th. A copy of the report of Internal Revenue agent referred to in the above mentioned Notice of Deficiency is attached hereto and marked "Exhibit B".

5th. The taxes in controversy are income and excess-profits taxes for the fiscal year ended May 31, 1936 as follows:

Income taxes	$6,323.54
Excess-Profits Taxes	940.63
	$7,264.17

Assignment of Error

6th. The Commissioner erred in refusing to allow as a deduction for the fiscal year ended May 31, 1936, depreciation of buildings amounting to $34,442.12.

7th. The Commissioner erred in refusing to allow as a deduction for the fiscal year ended May 31, 1936, depreciation of furniture and fixtures amounting to $16,190.60.

Statement of Fact

8th. Petitioner computed depreciation of its buildings and furniture and fixtures using as a base the cost of the various assets to the original [4] owner. The assets were acquired through a non-taxable reorganization.

9th. Wherefore, the petitioner prays that the Board may hear the proceeding, and that,

(a) It be determined that the Commissioner erroneously disallowed as deductions from income the amounts of $34,442.12 and $16,190.60 representing depreciation of buildings and furniture and fixtures for the fiscal year ended May 31, 1936.

(b) It be determined that there is no deficiency

in the petitioner's income and excess-profits tax liability for the fiscal year ended May 31, 1936.

G. C. CARLSON and
FRANK MERGENTHALER,
By FRANK MERGENTHALER
Counsel for Petitioner,
Room 1110, 548 So. Spring St.,
Los Angeles, California [5]

State of California
County of Los Angeles—ss.

R. F. Ingold being duly sworn according to law, says that he is the Vice President of the above named Palm Springs Holding Corporation, petitioner herein; that he has read the foregoing petition or had the same read to him, and is familiar with the statements contained therein, and that the facts stated are true, except as to those facts stated to be upon information or belief, and those facts he believes to be true.

R. F. INGOLD

Subscribed and sworn to before me this 24 day of August, 1938.

(Seal) IRMA HARRIS
Notary Public in and for the County of Los Angeles, State of California.

My commission expired Apr. 27, 1942.

I hereby certify that the foregoing is a true copy of the petition to the United States Board of Tax Appeals, signed by me on August 22, 1938.

FRANK MERGENTHALER
Counsel for Petitioner. [6]

EXHIBIT A

SN-R

Treasury Department
Internal Revenue Service
939 South Broadway
Los Angeles, Calif.
Jun. 1, 1938

Office of
Internal Revenue Agent in Charge
Los Angeles Division
IT:LA
FHG-90D
Palm Springs Holding Corporation,
El Mirador Hotel,
Palm Springs, California.
Sirs:

You are advised that the determination of your income tax liability for the taxable year(x) ended May 31, 1936, discloses a deficiency of $6,323.54, and that the determination of your excess-profits tax liability for the year(x) mentioned discloses a deficiency of $940.63, as shown in the statement attached.

In accordance with section 272(a) of the Revenue Act of 1934, notice is hereby given of the deficiencies mentioned. Within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiencies above stated.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward

it to the Internal Revenue Agent in Charge, 939 South Broadway, Los Angeles, California. The signing and filing of this form will expedite the closing of your return(x) by permitting an early assessment of the deficiencies, and will prevent the accumulation of interest, since the interest period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,
GUY T. HELVERING,
Commissioner.
By GEORGE D. MARTIN
Internal Revenue Agent in Charge

Enclosures:
Statement
Form 870 [7]

STATEMENT

IT:LA
FHG:90-D

Palm Springs Holding Corporation,
El Mirador Hotel,
Palm Springs, California.
Tax Liability for Taxable Year Ended
May 31, 1936

	Tax Liability	Tax Assessed	Deficiency
Income tax	$6,323.54	None	$6,323.54
Excess-profits tax	940.63	None	940.63

In making this determination of your income tax and excess-profits tax liabilities, careful consideration has been given to the internal revenue agent's report dated March 19, 1938.

The records of this office indicate that no reply has been received to letter dated May 3, 1938, again calling attention to your right to file a protest in this office and advising you that, in the event a consideration of any such protest filed by you did not result in agreement on the disputed issues, you would be privileged to request that your case be considered by the Los Angeles Division of the Technical Staff.

ADJUSTMENTS TO NET INCOME

Taxable Year Ended May 31, 1936

Net Loss as disclosed by your return		($4,643.31)
Unallowable deductions:		
(a) Excessive depreciation on buildings	$34,442.12	
(b) Excessive depreciation on furniture and fixtures	16,190.60	
Total adjustment		50,632.72
Net income as adjusted		$45,989.41

[8]

EXPLANATION OF ADJUSTMENTS

(a) Excessive depreciation on buildings:

Cost of buildings to May 31, 1935	$321,314.98	
Estimated life 20 years; annual depreciation		$16,065.75
Additions during taxable year	49,640.34	
Depreciation on additions, 5% for 7 months		1,447.85
Allowable depreciation on buildings		$17,513.60
Depreciation on buildings claimed		51,955.72
Excessive depreciation		$34,442.12

(b) Excessive depreciation on furniture and fixtures:

Cost of furniture and fixtures to May 31, 1935	$126,774.21	
Estimated life 8⅓ years; annual depreciation		$15,212.90
Additions during taxable year	11,334.46	
Depreciation on additions at 12%		680.07
Total allowable depreciation		$15,892.97
Depreciation on furniture and fixtures claimed		32,083.57
Excessive depreciation		$16,190.60

[9]

COMPUTATION OF TAX

Taxable Year Ended May 31, 1936

INCOME TAX

Net income as adjusted	$45,989.41
Income tax at 13¾%	$ 6,323.54
Income Tax Assessed:	
Original, account No. 859605	None
Deficiency of income tax	$ 6,323.54

EXCESS-PROFITS TAX

Net income as adjusted	$45,989.41
Less: 12½% of $217,414.11 declared value of capital stock, June 30, 1935	27,176.76
Balance subject to excess-profits tax	$18,812.65
Excess-profits tax at 5%	$ 940.63
Excess-profits tax assessed	None
Deficiency of excess-profits tax	$ 940.63

[10]

EXHIBIT B

IT:R

Treasury Department
Office of
Internal Revenue Agent in Charge
Internal Revenue Service
939 South Broadway
Los Angeles, California

In re: Income & Excess-Profits Taxes
Date of report: Mar. 19, 1938

Palm Springs Holding Corp.,
El Mirador Hotel,
Palm Springs, California.

Sirs:

Recommendation:

Years	Additional Tax	Overassessment	Penalties
F.Y. Ended 5/31/36	$6,323.54	(I.T.)	
F.Y. Ended 5/31/36	940.63	(E.P.T.)	
Total	$7,264.17		

The recommendations which this office proposes to make with respect to your income tax liability as the result of a recent examination by an internal revenue agent are shown in the statement attached.

If you acquiesce in the proposed tax liability the enclosed Form 870 should be executed and forwarded to this office. Your consent to the prompt assessment and collection of any deficiency indicated

will stop the running of interest on such deficiency upon a date not later than thirty days after the filing of the Form 870 properly executed.

Should you desire to make immediate payment without awaiting formal assessment and notice and demand, you should forward your remittance to the Collector of Internal Revenue at Los Angeles, California, enclosing this letter, or a copy thereof. If payment is so made the interest period will terminate on the date of payment, and interest on the deficiency at the rate of 6 per centum per annum to the date of your payment to the Collector computed from the due date of the first installment should be included in your remittance.

If you do not acquiesce in the proposed recommendations you should file a protest in writing with this office within 30 days from the date of this letter, stating therein the grounds for your exceptions. Any protest so filed will be given careful consideration, and, if you so desire, you will be given an opportunity for a hearing before the recommendations are forwarded to Washington. See instructions attached.

Arrangements will be made by this office upon your request to answer any questions which may occur to you in your review of these recommendations.

In any event please sign the enclosed form acknowledging receipt of this letter and related papers

and return such form to this office.

Respectfully,
GEORGE D. MARTIN
Internal Revenue Agent
in Charge.

Enclosures:
Statement of adjustments.
Form 870.
Form of acknowledgment. [11]

Palm Springs Holding Corp.

F. Y. Ended 5/31/36.

PRELIMINARY STATEMENT

Additional tax is due to the fact that in computing depreciation allowable corporation used as the basis the cost to the predecessor corporation, on the ground that the assets had been acquired in a nontaxable reorganization. In audit for the fiscal year 1935 a corrected basis was arrived at by means of a Valuation Report. Such report, with the improvements and additions made during the current year, has been used as a basis for the depreciation allowable in the year under consideration. The same rates were used in the current report.

Changes were discussed with Warren B. Pinney, President of the corporation, and as he had previously accepted the findings in the report for the previous year, he concedes that the present adjustments are in order. However, he desires a copy of this report for a consultation with his accountants before executing an agreement, Form 870.

An examination of the corporation's records indicates that for the calendar year 1936 a form 940 had been filed indicating a payroll of $117,033.40 on which a tax of one percent was due under the Social Security Act computing $1,170.33 with credit for tax paid the State of California (Unemployment Insurance) of $1,053.30, leaving amount due and paid to the Bureau of Internal Revenue of $117.03.

Table of Contents

Schedule	1	Adjustments to Net Income
	1-A	Explanation of Items
	2	Computation of Income and Excess-Profits Taxes
Exhibit	A	Balance Sheets, June 1, 1935 and May 31, 1936
	B	Analysis of Surplus
	C	Reconciliation of Income [12]

SCHEDULE 1

ADJUSTMENTS TO NET INCOME

Net income as disclosed by return		($ 4,643.31)
As corrected		45,989.41
Net adjustment as computed below		$50,632.72
Unallowable deductions and additional income:		
(a) Depreciation on buildings overstated	$34,442.12	
(b) Depreciation on furniture & fixtures overstated	16,190.60	
Net adjustment as above		$50,632.72

SCHEDULE 1-A
EXPLANATION OF ITEMS

(a) Depreciation on buildings overstated $34,442.12

Overstatement is due to fact that corporation used as a basis for depreciation deduction cost to predecessors on the theory that same was acquired by a nontaxable reorganization. In audit of F. Y. 1935 return it was held depreciation should be based upon a cost basis. A valuation report accompanies such audit. In said report it is the basis of the buildings to June 1, 1935 that totalled

$321,314.98	Computing 20 Yrs. life figures	$16,065.75
	To arrive at current year's depreciation add	
49,640.34	current additions at 5% for 7 months— Hotel's season began 11/1/1935	1,447.85
$370,955.32		
	Allowable depreciation	$17,513.60
	Amount claimed	51,955.72
	Amount overstated	$34,442.12

Amount claimed per books was $20,862.88.

(b) Depreciation on furniture & fixtures overstated $16,190.60

Same explanation as to buildings applies here.

[13]

SCHEDULE 1-A (Continued)

In valuation report referred to basis of furniture and fixtures to June 1, 1935 totalled

$126,774.21	Computing depreciation on 12% basis figures	$15,212.90
	To arrive at current year's depreciation, add	
11,334.46	current additions at 12%	
	Rate for 6 months	680.07
$138,108.67		
	Allowable depreciation	$15,892.97
	Amount claimed	32,083.57
	Amount overstated	$16,190.60

Amount claimed per books is $13,848.49.

Unchanged items verified from books and found correct. Operating expenses contain no unallowable deductions. Hotel is open for 8 months of the year and during the closed period is subject to considerable expense in keeping same in good condition. As the hotel is located in the desert country and it is extremely hot in the closed season, it is necessary to use all precautions in such season.

SCHEDULE 2

COMPUTATION OF TAX

Income Tax

Net Income per Schedule 1	$45,989.41
Less: Interest on Liberty Bonds	None
Amount subject to Income Tax	$45,989.41
Income Tax at 13¾% on $45,989.41	$ 6,323.54
Total Tax assessable	$ 6,323.54
Tax previously assessed	None
Additional income tax to be assessed	$ 6,323.54

[14]

SCHEDULE 2 (Continued)

EXCESS-PROFITS TAX

Net Income for Excess-Profits Tax computation	$45,989.41
Declared value of capital stock for year ended June 30, 1935—$217,414.11	
Credit 12½% of $217,414.11	27,176.76
Amount subject to Excess-Profits Tax	$18,812.65
Excess-Profits tax, 5% of $18,812.65	$940.63
Excess-Profits tax assessable	$940.63
Excess-Profits tax previously assessed	None
Additional excess-profits tax to be assessed	$940.63

[15]

EXHIBIT A

BALANCE SHEETS

Assets	As of June 1, 1935 Per Books	Dr.	Cr.	Corrected	As of May 31, 1936 Per Books	Dr.	Cr.	Corrected
Cash	45,492.88			45,492.88	33,561.57			33,561.57
Accts. Receivable	3,885.40			3,885.40	6,078.31			6,078.31
Inventories, Food, S. Bev.	4,612.42			4,612.42	4,976.57			4,976.57
Prepaid Insurance	5,765.46			5,765.46	5,389.57			5,389.57
Prepaid Taxes	507.09			507.09	716.30			716.30
Bond Discount & Expense	4,485.02			4,485.02	3,877.10			3,877.10
Sundry Prepaid Expense	1,522.97			1,522.97	1,356.19			1,356.19
Buildings	300,712.47	20,602.51(a)		321,314.98	350,352.81	20,602.51(a)		370,955.32
Furniture & Fixtures	109,737.14	17,037.07(a)		126,774.21	121,071.60	17,037.07(a)		138,108.67
Miscellaneous Equipment	6,668.50			6,668.50	7,288.50			7,288.50
Delivery Equipment	1,294.57			1,294.57	1,294.57			1,294.57
Land	15,051.00	6,342.88(a)		21,393.88	31,268.73	6,342.88(a)		37,611.61
Whitewater Mutual Water Co. Stk.	3,775.00	801.16(a)		4,576.16	3,775.00	801.16(a)		4,576.16
					500.00			500.00
Discount on Preferred Stock	39,900.00			39,900.00	39,900.00			39,900.00
	543,409.92			588,193.54	611,406.82			656,190.44
Liabilities								
Reserve for Doubtful Accts.	1,500.00			1,500.00	1,500.00			1,500.00
Reserve for Depreciation on Buildings	53,042.19)	1,082.34(c)		84,773.07	73,905.07)	1,082.34(b) 1,304.80(d)		118,503.28
Reserve for Furniture & Fixtures	31,994.44)				45,842.93)			
Reserve for Del. Equipment	818.78)				1,142.42)			
Reserve for Misc. Equipment	6,915.06			6,915.06	6,564.25			6,564.25
Construction Res. Water System	2,196.34			2,196.34				
Accts. Payable	4,004.41			4,004.41	8,263.66			8,263.66
Mortgages Payable	57,000.00			57,000.00	55,000.00			55,000.00
Accrued Interest	1,662.50			1,662.50	1,604.20			1,604.20
Accrued Taxes	217.00			217.00	700.00			700.00
Due Officers	1,230.99			1,230.99	2,948.47			2,948.47
Reserve for Contingencies	4,200.00			4,200.00	12,500.00			12,500.00
Capital Stock Preferred	220,800.00			220,800.00	220,800.00			220,800.00
Capital Stock Common	15,000.00			15,000.00	15,000.00			15,000.00
Surplus	133,311.66)		(c) 45,865.96		133,311.66)			
Undivided Profits	9,516.55)			188,694.17	32,324.16)		(c & e) 47,170.76	212,806.58
	543,409.92	45,865.96	45,865.96	588,193.54	611,406.82	47,170.76	47,170.76	656,190.44

Adjustments per R. A. R. F. Y. 1935

(a) Revaluation of assets	44,783.62	
(b) Depreciation disallowed	1,082.34	
(c) Surplus		45,865.96

Adjustments per R. A. R. F. Y. 1936

(d) Depreciation disallowed	1,304.80	
(e) Surplus		1,304.80

Adjustments per R. A. R. F. Y. 1935 not made on books.

Name Palm Springs Holding Corp.

EXHIBIT B Year ended 5/31/1936

ANALYSIS OF SURPLUS AND RECONCILIATION OF AMENDED SURPLUS WITH AMENDED TAXABLE NET INCOME

Item		Per Books		Amended
Surplus beginning of period			$142,828.21	$188,694.17
Add				
Income per books and corrected taxable net income	$36,055.61		$45,989.41	
Nontaxable income for period:				
Federal C. S. T. prepaid 5/31/36			58.00	
Other credits to surplus during period:				
		36,055.61		46,047.41
		$178,883.82		$234,741.58
Deduct				
Dividends (dates):				
September 30, 1935	$ 6,624.00		$ 6,624.00	
January 31, 1936	6,624.00		6,624.00	
Income taxes				
Unallowable deductions:				
Additions to reserve			8,300.00	
Donations			370.00	
Federal C. S. T. prepaid 5/31/35			17.00	
Other charges to surplus during period:				
		13,248.00		21,935.00
Surplus end of period		$165,635.82		$212,806.58

Name Palm Springs Holding Corp.

EXHIBIT C Year ended 5/31/36

RECONCILIATION OF INCOME PER BOOKS WITH INCOME PER RETURN AND WITH TAXABLE NET INCOME

Net income per books		$36,055.61
Additions		
Additions to Reserve for Contingencies	$ 8,300.00	
Donations	370.00	
Capital Stock Tax prepaid 5/31/1935	17.00	8,687.00
		$44,742.61
Deductions		
Capital Stock Tax prepaid 5/31/1936	$ 58.00	
Additional depreciation based upon cost to predecessors	49,327.92	49,385.92
Net income per return of taxpayer		($ 4,643.31)

[Endorsed]: U.S.B.T.A. Filed Aug. 29, 1938 [18]

[Title of Board and Cause.]

ANSWER

The Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, for answer to the petition filed in the above-entitled appeal, admits and denies as follows:

1st. Admits the allegations contained in paragraph 1st. of the petition.

2nd. Admits the allegations contained in paragraph 2nd. of the petition.

3rd. Admits the allegations contained in paragraph 3rd. of the petition.

4th. Denies the allegations contained in paragraph 4th. of the petition.

5th. Admits the taxes in controversy are income and excess-profits taxes for the fiscal year ended May 31, 1936. Denies the remaining allegations contained in paragraph 5th. of the petition. [19]

6th. and 7th. Denies the allegations of error contained in paragraphs 6th. and 7th. of the petition.

8th. Denies the allegations of fact contained in paragraph 8th. of the petition.

Denies generally and specifically each and every allegation contained in the petition not hereinbefore expressly admitted, qualified, or denied.

Wherefore, it is prayed that the petition be denied and that the respondent's determination be in all respects approved.

(Signed) J. P. WENCHEL
FTH
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:

ALVA C. BAIRD,
FRANK T. HORNER,
E. A. TONJES,
Special Attorneys,
Bureau of Internal Revenue.

EAT/evl 10/7/38

[Endorsed]: U.S.B.T.A. Filed Oct. 13, 1938. [20]

[Title of Board and Cause.]

Frank Mergenthaler, Esq., for the petitioner.

E. A. Tonjes, Esq., and Frank T. Horner, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION.

This proceeding involves deficiencies in petitioner's income tax and excess-profits tax liability for the taxable year ended May 31, 1936 determined by respondent in the respective amounts of $6,323.54 and $940.63, arising by reason of respondent's disallowance in part of deductions claimed as depreciation on buildings owned by petitioner and as depreciation on furniture and fixtures. The question to be determined is what basis for depreciation these assets should have in the hands of petitioner.

[21]

FINDINGS OF FACT.

The parties have filed herein a stipulation of facts which is adopted by reference as our findings. With the exception of the exhibits attached to the stipulation, it reads as follows:

1. The petitioner is a corporation organized and existing under the laws of the State of California, with its principal office at the El Mirador Hotel of Palm Springs, California.

2. The petitioner filed its Federal income and excess-profits tax returns for the fiscal year ended May 31, 1936 with the Collector of Internal Rev-

enue for the Sixth District of California, at Los Angeles, California.

3. Palm Springs Hotel Co. was incorporated under the laws of the State of Nevada in 1927. It constructed and owned the El Mirador Hotel at Palm Springs, California, which hotel was placed in operation in January of 1928. This corporation had outstanding an issue of closed first mortgage seven per cent sinking fund gold bonds secured by a trust indenture given by said Palm Springs Hotel Co. to California Trust Co. as trustee, which was a lien upon the real property of said Palm Springs Hotel Co., which was the El Mirador Hotel property; the amount of said bonds issued and outstanding in July 1932 was $309,000. The said Palm Springs Hotel Co., on September 1, 1931, had issued and outstanding 3,213 shares of preferred stock of the par value of $100 each and 110 shares of common stock without nominal or par value.

4. The El Mirador Hotel was leased by the Palm Springs Hotel Co. to Palm Springs Hotel Operating Co., which subsequently changed its name to El Mirador Hotel Operating Co., and which latter company owned the [22] furniture and fixtures in the hotel. A chattel mortgage secured by such furniture and fixtures was given by the said lessee to Palm Springs Hotel Co. as security for performance of the terms of the lease. The said lease and chattel mortgage were assigned and pledged by Palm Springs Hotel Co. under the said trust indenture as part of the security for its said bond

issue. On September 7, 1931, the said El Mirador Hotel Operating Co. had issued and outstanding 1253 shares of its common capital stock having a par value of $100 per share. Prior to the date the outstanding stock of the El Mirador Hotel Operating Co. was sold for nonpayment of assessments as hereinafter set forth the Palm Springs Hotel Co. was the owner of 738 shares of the capital stock of El Mirador Hotel Operating Co.

5. (a) In the spring of 1931 both the Palm Springs Hotel Co. and El Mirador Hotel Operating Co. were in financial difficulties and were unable to meet their respective obligations, having sustained large operating deficits. The Palm Springs Hotel Co. levied an assessment on its capital stock amounting to $20 per share, which assessment remained unpaid, and on September 2, 1931, that company, pursuant to the laws of the State of Nevada, sold for non-payment of said assessment all of its capital stock with the exception of five shares of its common stock and five shares of its preferred stock owned by Warren B. Pinney and upon which the assessment was paid by Warren B. Pinney, the president of the corporation. The said Palm Springs Hotel Co. bought in all of the said stock at the said assessment sale with the exception of the said ten (10) [23] shares, which remained outstanding as qualifying shares, and at all times up to and including the trustee's sale hereinafter mentioned the said Warren B. Pinney was the sole stockholder of the Palm Springs Hotel Co.

(b) The El Mirador Hotel Operating Co. also levied an assessment on its capital stock amounting to $20 per share, which assessment remained unpaid, and on September 8, 1931, that company, pursuant to the laws of the State of California, sold for non-payment of said assessment all of its capital stock with the exception of ten (10) shares owned by Warren B. Pinney, the assessment on which was paid by Warren B. Pinney, who was president of said company. The said El Mirador Hotel Operating Co. bought in all of said stock at the said assessment sale with the exception of said ten (10) shares, and at all times up to and including the trustee's sale hereinafter mentioned the said Warren B. Pinney was the sole stockholder of the El Mirador Hotel Operating Co.

6. Under date of August 20, 1931, a bondholders protective committee for Palm Springs Hotel Co. first mortgage seven percent sinking fund gold bonds was formed to protect the interests of the holders of the said bonds. Hereto annexed, marked "Exhibit A" and made a part of this stipulation, is a true and correct copy of the deposit agreement under which the bonds were deposited with the said bondholders protective committee. Bonds having a par value of $167,500 were deposited with the said committee under the terms of the said deposit agreement.

7. Palm Springs Holding Corporation, the petitioner herein, was incorporated under the laws of the State of California on April 1, 1932. [24] Its

authorized capital stock consisted of 3,000 shares of 6% non-cumulative preferred stock of a par value of $100 each and 7,500 shares of common stock without par value. Hereto annexed marked "Exhibit B" and "Exhibit C" respectively are true and correct copies of the certificates of preferred and common stock of the said Palm Springs Holding Corporation. Under a permit granted by the Commissioner of Corporations of the State of California on May 4, 1932, shares of this corporation were issued, during the month of May 1932 in exchange for bonds of Palm Springs Hotel Co. and for other considerations as follows:

	Par value bonds exchanged	Stock of Pet. issued	
		Pfd. shs.	Common shs.
(a) Holders of said bonds of Palm Springs Hotel Co.	$173,000	1,038	692
(b) R. D. Lacoe	119,000	714	476
(c) R. D. Lacoe	none		6,332
	$292,000	1,752	7,500

The consideration for issuance of the several lots of shares was as follows:

(a) 6 shares of preferred stock and 4 shares of common stock were issued for each $1,000 bond in accordance with the plan of reorganization set forth in the letter of the Bondholders' Protective Committee dated March 3, 1932, a copy of which letter is hereto annexed marked "Exhibit D" and made a part hereof by reference.

(b) R. D. Lacoe was the owner of $119,000 par value of bonds which had not been deposited with

the Bondholders' Protective Committee. 714 shares of preferred stock and 476 shares of common stock of the petitioner were issued to R. D. Lacoe in accordance with the said plan of reorganization in exchange for said bonds having a par value of $119,000. [25]

(c) For his agreement to pay the costs of incorporating the petitioner up to $1,000, and for his agreement to loan moneys to the petitioner, all as set forth in the said plan of reorganization, the petitioner issued to said R. D. Lacoe all of its common capital stock not required to be issued in exchange for bonds, namely, 6332 shares.

8. On or about May 21, 1932, the trustee under said trust indenture declared the principal of all the said bonds secured thereby to be immediately due and payable. On July 15, 1932, the said trustee held a sale pursuant to the terms of said trust indenture at which the properties pledged under the trust indenture were sold to the highest bidder. Palm Springs Holding Corporation, the petitioner herein, was the successful bidder at the said sale and acquired all of the properties of Palm Springs Hotel Co., including said lease and chattel mortgage. The bid price was $61,800 which was satisfied as follows:

(a) Payment of cash, amounting to	$18,767.96
(b) By the delivery to the trustee of bonds of Palm Springs Hotel Co. having a face value of $292,000 for the balance of	43,032.04

The said properties were acquired by the petitioner subject to obligations amounting to $38,949.76, which were prior to the lien of said bonds, of which amount $13,500 represented obligations constituting a lien on the said furniture and fixtures in the said El Mirador Hotel.

9. On the 15th day of July, 1932, the California Trust Co., trustee under said trust indenture, conveyed said properties, including the said [26] lease and chattel mortgage, to the petitioner herein. Thereafter petitioner instituted foreclosure proceedings thereon in the Superior Court of the State of California, in and for the County of Riverside, action No. 23296, against Palm Springs Hotel Co. and the El Mirador Hotel Operating Co. This action proceeded to a decree of foreclosure in favor of the petitioner, the amount of the judgment for indebtedness of the El Mirador Hotel Operating Co. under the said lease and chattel mortgage being $77,918.79, and on August 2, 1932, the Sheriff of Riverside County, California, pursuant to said decree of foreclosure sold to the Palm Springs Holding Corporation, the petitioner, the furniture and fixtures in the El Mirador Hotel formerly owned by the El Mirador Hotel Operating Co. for a bid price of $20,179.25. Said furniture and fixtures constituted all of the properties of said El Mirador Hotel Operating Co.

10. W. B. Pinney was president of Palm Springs Hotel Co. and of El Mirador Hotel Operating Co., and from August 12, 1932, was president

of Palm Springs Holding Corporation, the petitioner. By agreement between said W. B. Pinney and R. D. Lacoe, reached prior to the issuance of any shares of the petitioner, W. B. Pinney received 1,000 shares of common stock of petitioner, which shares were transferred to said Pinney from said Lacoe on May 19, 1932, for services of said Pinney in the reorganization and as an inducement to continue as manager of the hotel.

11. The cost of the buildings to Palm Springs Hotel Co., including all additions up to July 15, 1932, on which date said buildings were acquired by petitioner as aforesaid, was $686,731.97. Subsequently the petitioner made additions to said buildings up to May 31, 1936, which cost the petitioner $82,652.81, which amount represented an increase in [27] the cost of said property to petitioner. The useful life of the said buildings was twenty (20) years from January 1, 1928.

12. The cost to El Mirador Hotel Operating Co. of the furniture and fixtures acquired by petitioner on August 2, 1932, as aforesaid, including all additions to said date, was $232,544.10. Subsequently petitioner acquired additional furniture and fixtures up to May 31, 1936 at a cost of $40,485.18. The useful life of said furniture and fixtures was twelve (12) years from the date of acquisition new.

13. In the issuance of the capital stock of the petitioner as set forth in paragraph 7 hereof, no

stock of the petitioner was issued to any stockholders or former stockholders of the Palm Springs Hotel Co. and the El Mirador Hotel Operating Co. for any rights which any of such stockholders might have had as stockholders of said companies.

OPINION

KERN: The first question for our decision is whether petitioner is entitled, as a basis for depreciation of its buildings, to the depreciated cost of such buildings to the Palm Springs Holding Co. It is petitioner's contention that it acquired these buildings in connection with a reorganization and immediately after the transfer an interest in such property of more than 30 per centum remained in the same persons, and that, therefore, its basis of depreciation should be the same as it would have been in the hands of the Palm Springs Hotel Co., by virtue of sections 113 (a) (7), [28] 113 (b) and 114 (a) of the Revenue Act of 1934, set out in the margin.[1] In support of this contention petitioner

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Sec. 113. Adjusted Basis for Determining Gain or Loss.

(a) Basis (Unadjusted) of Property.—The basis of property shall be the cost of such property; except that—

* * * * * * *

(7) Transfers to Corporation where control of Property remains in same persons.—If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons

cites Commissioner v. Kitselman, 89 Fed. (2d) 458, cert. denied 302 U. S. 709; Newberry Lumber & Chemical Co. v. Commissioner, 94 Fed. (2d) 447; Frederick L. Leckie, 37 B.T.A. 252; and Marlborough House, Inc., 40 B.T.A. 881. Respondent does not deny that this property was acquired by petitioner as a step in a reorganization plan or that after the transfer an interest of more than 50 per centum remained in the same persons, but seeks to distinguish this proceeding from the cases above cited because in those cases the foreclosure sale pre-

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or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

* * * * * * *

(b) Adjusted Basis.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

Sec. 114. Basis for Depreciation and Depletion.

(a) Basis for Depreciation.—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

ceded the transfer of the property to the new corporation, while in this proceed- [29] ing the bondholders exchanged their bonds for stock in the new corporation (the petitioner) and the latter foreclosed the property and applied the bonds in substantial payment therefor. We are not of the opinion that this chronological difference constitutes a valid distinction. The steps taken were obviously pursuant to and part of a plan of reorganization resulting ultimately in the acquisition by petitioner of the assets of the Palm Springs Hotel Co., and the acquisition by the bondholders of the latter of preferred stock of petitioner. Respondent also urges that it would not be proper to permit "the bondholders [of the Hotel Co.] whose investment originally cost them but $300,000 to be parties to a nontaxable reorganization, and yet, in effect, step their investment up approximately $500,000 for depreciation purposes in a corporation growing out of such a reorganization." This argument seems to be directed against the wisdom of the rule adopted in the above cited cases and not by way of distinguishing them in principle from the instant proceeding. On the authority of those cases our decision on this issue will be for petitioner. See also Alabama Asphaltic Limestone Co., 41 B.T.A. ....

The second question for our decision is whether petitioner is entitled as a basis for depreciation of its furniture and equipment to their depreciated cost to the El Mirador Hotel Operating Co. This company was not a party to the reorganization. Its

sole connection with the reorganization was by reason of the fact that it was the lessee of the buildings of the Hotel Co., and to secure its obligations under the lease had executed to the Hotel Co., a chattel mortgage covering the furniture and [30] fixtures used by it in operating the leased premises and acquired by it at a cost of $232,544.10. This lease and mortgage were assigned by the Hotel Co. to the trustee under the trust indenture securing its bonds as further security. At the time of the reorganization of the Hotel Co. the El Mirador Co. was indebed to it under its lease in the sum of $77,918.79. By virtue of the reorganization, the trustee under the trust indenture conveyed this lease and chattel mortgage to petitioner. Subsequently petitioner instituted foreclosure proceedings under this chattel mortgage and at the foreclosure sale bought the furniture and fixtures for a bid price of $20,179.25. Petitioner contends that it acquired the furniture and fixtures in connection with a reorganization and by reason of the sections of the Revenue Act already quoted is entitled to a basis of depreciation as to the furniture and fixtures of $232,544.10, the cost to the El Mirador Co.

We are unable to agree with this contention. By virtue of the wiping out of the stockholders' interests in the Palm Springs Hotel Co., the bondholders of that company were "stepped up" to the position of stockholders as to its assets according to the holding of the cases cited, and with regard to these assets the steps taken by the bondholders con-

stituted, as we have held, a transfer in connection with a reorganization. The bondholders of the Palm Springs Hotel Co. were not, however, "stepped up" to a position of stockholders in the El Mirador Hotel Operating Co. and could not be considered as owners of the physical assets of that company. They merely had a chose in action against that company. What petitioner acquired by transfer in connection with the reorganization [31] was the assets of the Palm Springs Hotel Co. including the lease obligation of the El Mirador Co. to the Hotel Co., together with the chattel mortgage securing it. Petitioner, however, is not seeking depreciation on this chose in action and its basis is not in question. Subsequent to the reorganization it sought to realize on the chose in action and the chattel mortgage securing it. In this it acted as the assignee of the original mortgage and was entitled to what rights the mortgagee Hotel Co. had. When it foreclosed the mortgage and purchased the property, its basis as to the property would be the same as it would be to any mortgagee acquiring property on foreclosure. That basis is not cost to the mortgagor. The stipulated facts do not show that either the bid price at the foreclosure sale, or the fair market value of the furniture and fixtures at the time acquired by the petitioner were in excess of the basis allowed by the respondent. See Helvering v. Midland Mutual Life Insurance Co., 300 U. S. 216; Suncrest Lumber Co., 25 B.T.A. 375; Pelham Hall Co., 33 B.T.A. 329; La Arcada Bondholders Com-

mittee, 35 B.T.A. 80. On this question we affirm the determination of the respondent.

Enter:

Decision will be entered under Rule 50.

Entered Mar. 23, 1940.

(Seal) [32]

United States Board of Tax Appeals
Washington.

Docket No. 95262

PALM SPRINGS HOLDING CORP.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the Memorandum Findings of Fact and Opinion entered in the above entitled proceeding on March 23, 1940, counsel for the respondent filed, on April 16, 1940, a computation of deficiency. At the hearing under Rule 50 held on May 22, 1940, respondent's computation was not contested by petitioner. Therefore, it is

Ordered and decided: That for the taxable year ended May 31, 1936 there is a deficiency in petitioner's income tax in the amount of $3,612.78, and that there is no deficiency in excess-profits tax.

(s) JOHN W. KERN
Member.

In the United States Circuit Court of Appeals
for the Ninth Circuit

B.T.A. No. 95262

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner on Review,

v.

PALM SPRINGS HOLDING CORPORATION,

Respondent on Review.

PETITION FOR REVIEW AND ASSIGNMENTS OF ERROR

To the Honorable Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

Now comes the Commissioner of Internal Revenue, by his attorneys, Samuel O. Clark, Jr., Assistant Attorney General, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and John M. Morawski, Special Attorney, Bureau of Internal Revenue, and respectfully shows:

I.

Jurisdiction

The petitioner on review is the duly appointed, qualified and acting Commissioner of Internal Revenue, hereinafter referred to as the Commissioner, holding his office by virtue of the laws of the United States.

The respondent on review, Palm Springs Holding Corporation (hereinafter referred to as the tax-

payer), is a corporation organized and existing under the laws of the State of California, with its principal office [34] at the El Mirador Hotel of Palm Springs, California. The said Palm Springs Holding Corporation filed its Federal income and excess-profits tax return for the fiscal year ended May 31, 1936, with the Collector of Internal Revenue for the Sixth District of California, at Los Angeles, California, and within the judicial circuit of the United States Circuit Court of Appeals for the Ninth Circuit.

The Commissioner files this petition pursuant to the provisions of Section 1141 of the Internal Revenue Code.

II.

Prior Proceedings

On June 1, 1938 the Commissioner determined deficiencies in income and excess-profits taxes for the taxable year ended May 31, 1936 in the respective amounts of $6,323.54 and $940.63, and sent to the taxpayer by registered mail a notice of said deficiencies, in accordance with the provisions of existing internal revenue laws. Thereafter, and on August 29, 1938, the taxpayer filed a petition for a redetermination of said deficiencies by the United States Board of Tax Appeals.

The case was tried before the Board of Tax Appeals on September 27, 1939, at Los Angeles, California.

On March 23, 1940, the Board entered its memorandum findings of fact and opinion, and on May

25, 1940 entered its decision that for the taxable year ended May 31, 1936 there is a deficiency in taxpayer's income tax in the amount of $3,612.78, and that there is no deficiency in excess-profits tax. [35]

III.

Nature of Controversy

The question involved is whether the taxpayer is entitled to determine depreciation of its buildings on the basis of cost to it at foreclosure sale, as contended for by the Commissioner, or on the basis of cost to the former owner, the Palm Springs Hotel Company, as contended for by the taxpayer.

The Palm Springs Hotel Company owned the El *Mirado* Hotel at Palm Springs, California. It had outstanding in July, 1932 $309,000.00 of First Mortgage bonds which were a lien on the El Mirador Hotel property. The El Mirador Hotel was leased to El Mirador Hotel Operating Company, which owned the furniture and fixtures in the hotel. A chattel mortgage, secured by such furniture and fixtures, was given by the lessee to Palm Springs Hotel Company as security for performance of the terms of the lease. The lease and chattel mortgage were pledged by Palm Springs Hotel Company as part of the security for its bond issue.

The taxpayer, Palm Springs Holding Corporation was incorporated April 1, 1932, and on May 4, 1932, shares of its capital stock were issued in exchange for $292,000 par value of bonds of Palm

Springs Hotel Company. On or about May 21, 1932, the principal of said bonds were declared due and payable, and on July 15, 1932 the properties pledged under the trust indenture were sold to the highest bidder. The taxpayer was the successful bidder and acquired all of the properties of Palm Springs Hotel Co., including the lease and chattel mortgage. The bid price was $61,800, which [36] was satisfied by payment of cash amounting to $18,767.96 and by delivery of $292,000 of bonds for the balance of $43,032.04.

In its return for the fiscal year ended May 31, 1936, the taxpayer claimed depreciation of $51,955.72 on buildings, based upon the cost to the predecessor corporation plus subsequent improvements. The cost of the buildings to Palm Springs Hotel Company up to July 15, 1932, was $686,731.97. The cost of improvements from July 15, 1932 to May 31, 1936, was $82,652.81. The Commissioner, in his notice of deficiency, allowed depreciation of $17,513.60 on buildings based on a revised cost of buildings to May 31, 1935. $321,314.98 plus additions during taxable year, $49,640.34, or a total cost of $370,955.32. The figures used by the Commissioner were based upon valuation at date of foreclosure plus subsequent additions.

The Board of Tax Appeals, however, decided this issue for the taxpayer holding that the taxpayer may use as a base for depreciation of buildings the cost to the Palm Springs Hotel Company.

IV.

ASSIGNMENTS OF ERROR

The Commissioner avers that in the record and proceeding before the Board of Tax Appeals and in the opinion and final decision rendered and entered by the Board of Tax Appeals, manifest error occurred and intervened to the prejudice of the Commissioner who now assigns the following errors and each of them, which he avers occurred in said record, proceeding, opinion and final decision so rendered and entered by the Board of Tax Appeals: [37]

1. The Board erred in holding that for the taxable year ended May 31, 1936 there is a deficiency in taxpayer's income tax in the amount of only $3,612.78, and that there is no deficiency in excess-profits tax.

2. The Board erred in failing to hold that there are deficiencies in income tax and excess-profits tax for the taxable year ended May 31, 1936 in the respective amounts of $6,323.54 and $940.63.

3. The Board erred in holding that on authority of the cases cited by it, the taxpayer acquired the hotel buildings in question in connection with a reorganization and immediately after the transfer an interest in such property of more than 50 per centum remained in the same persons and that the taxpayer's basis of depreciation should be the same as it would have been in the hands of the Palm

Springs Hotel Co., by virtue of sections 113 (a) (7), 113(b) and 114(a) of the Revenue Act of 1934.

4. The Board erred in holding that the steps taken were obviously pursuant to and part of a plan of reorganization resulting ultimately in the acquisition by taxpayer of the assets of the Palm Springs Hotel Co., and the acquisition by the bondholders of the latter of preferred stock of the taxpayer.

5. The Board erred in failing to hold that the taxpayer did not acquire its buildings in comection with a statutory reorganization and that the basis for determining depreciation on the buildings is the cost to the taxpayer upon purchase at foreclosure sale.

6. The Board erred in failing to sustain the Commissioner's determination as to depreciation allowable on buildings.

7. The Board erred in that its decision is not supported by the evidence and is contrary to law.

[38]

Wherefore, the Commissioner petitions that the decision of the Board of Tax Appeals be reviewed by the United States Circuit Court of Appeals for the Ninth Circuit, that a transcript of the record be prepared in accordance with law and with the rules of said Court and transmitted to the Clerk of said Court for filing, and that appropriate action

be taken to the end that the errors complained of may be reviewed by said Court.

SAMUEL O. CLARK, JR.
Assistant Attorney General

(Signed) J. P. WENCHEL
RLW
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:

J. M. MORAWSKI,
Special Attorney,
Bureau of Internal Revenue.

[39]

United States of America
District of Columbia—ss.

John M. Morawski, being duly sworn, says that he is a Special Attorney in the Bureau of Internal Revenue and as such is duly authorized to verify the foregoing petition for review; that he has read said petition and is familiar with the contents thereof; that said petition is true of his own knowledge except as to the matters therein alleged on information and belief, and as to those matters he believes it to be true.

JOHN M. MORAWSKI
Special Attorney,
Bureau of Internal Revenue.

Sworn and subscribed to before me this 3rd day of August, 1940.

GEORGE W. KREIS
Notary Public.

My commission expires November 15, 1942.

[Endorsed]: U.S.B.T.A. Filed Aug. 10, 1940. [40]

In the United States Circuit Court of Appeals
for the Ninth Circuit

B.T.A. Docket No. 95262

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner on Review,

v.

PALM SPRINGS HOLDING CORPORATION,

Respondent on Review.

NOTICE OF FILING PETITION FOR REVIEW

To: Palm Springs Holding Corporation,
El Mirador Hotel,
Palm Springs, California.

You are hereby notified that the Commissioner of Internal Revenue did on the 10th day of August, 1940, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Ninth Circuit, of the decision of the Board heretofore rendered in the above-entitled cause. A copy of the petition for review and the assignments of error as filed is hereto attached and served upon you.

Dated this 10th day of August, 1940.

(Signed) J. P. WENCHEL
RLW
Chief Counsel,
Bureau of Internal Revenue.

Personal service of the above and foregoing notice, together with a copy of the petition for review and assignments of error mentioned therein, is hereby acknowledged this 12 day of August, 1940.

PALM SPRINGS HOLDING CORPORATION
By W. B. PINNEY, Pres.
Respondent on Review.

[Endorsed]: U.S.B.T.A. Filed Aug. 20, 1940. [41]

In the United States Circuit Court of Appeals for the Ninth Circuit

B.T.A. Docket No. 95262

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner on Review,

v.

PALM SPRINGS HOLDING CORPORATION,

Respondent on Review.

NOTICE OF FILING PETITION FOR REVIEW

To: Frank Mergenthaler, Esq.
548 South Spring Street,
Los Angeles, California.

You are hereby notified that the Commissioner of Internal Revenue did on the 10th day of Au-

gust, 1940, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Ninth Circuit, of the decision of the Board heretofore rendered in the above-entitled cause. A copy of the petition for review and the assignments of error as filed is hereto attached and served upon you.

Dated this 10th day of August, 1940.

(Signed) J. P. WENCHEL
RLW
Chief Counsel,
Bureau of Internal Revenue.

Personal service of the above and foregoing notice, together with a copy of the petition for review and assignments of error mentioned therein, is hereby acknowledged this 12 day of August, 1940.

(Sgd) FRANK MERGENTHALER
Counsel for Respondent on Review.

[Endorsed]: U.S.B.T.A. Filed Aug. 20, 1940. [42]

In the United States Circuit Court of Appeals
for the Ninth Circuit

B.T.A. No. 95262

PALM SPRINGS HOLDING CORPORATION,
Petitioner on Review,

vs.

GUY T. HELVERING, Commissioner of Internal Revenue,
Respondent on Review.

PETITION FOR REVIEW AND ASSIGNMENTS OF ERROR

To the Honorable Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

Comes now the Palm Springs Holding Corporation, the Petitioner on Review, above named, (hereinafter referred to as the taxpayer) by its attorney, Frank Mergenthaler, and respectfully shows:

I.

Jurisdiction

That the Petitioner on Review is a corporation organized and existing under the laws of the State of California, with its principal office at the El Mirador Hotel, Palm Springs, California. Said Palm Springs Holding Corporation filed its Federal income and excess-profits tax return for the fiscal year ended May 31, 1936, with the Collector of Internal Revenue for the Sixth District of California, at Los Angeles, California [43] and within

the judicial circuit of the United States Circuit Court of Appeals for the Ninth Circuit.

The Respondent on Review is the duly appointed, qualified and acting Commissioner of Internal Revenue, and is hereinafter referred to as the Commissioner, who holds his office by virtue of the laws of the United States.

The Petitioner on Review files this Petition pursuant to the provisions of §1141 of the United States Internal Revenue Code, for a review of a portion of the decision of the United States Board of Tax Appeals.

II.

Prior Proceedings

On or about the 1st day of June, 1938, the Commissioner of Internal Revenue mailed to the taxpayer a ninety day letter advising it of a determination of deficiency in its income tax liability for the taxable year ended May 31, 1936, in the sum of $6,323.54, and a determination of deficiency in its excess-profits tax liability for the same year in the sum of $940.63. On the 29th day of August, 1938, the taxpayer filed a petition for a redetermination of said deficiencies by the United States Board of Tax Appeals. On the 13th day of October, 1938, the Commissioner filed his Answer to said Petition, denying the material allegations of said petition.

The case being at issue it was tried before the United States Board of Tax Appeals on September 27, 1939, at Los Angeles, California. On the 23rd

day of March, 1940, the [44] United States Board of Tax Appeals entered its Memorandum Findings of Fact and Opinion, and on May 25, 1940, the said Board entered its Decision that for the taxable year ended May 31, 1936, there is a deficiency in the taxpayer's income tax in the amount of $3,612.78, and that there is no deficiency in excess-profits tax.

III.

Nature of Controversy

The question involved is whether the taxpayer is entitled to determine depreciation of its furniture and fixtures on the basis of their fair market value at the date of foreclosure of the chattel mortgage, as contended for by the Commissioner, or on the basis of cost to the former owner.

A corporation known as the Palm Springs Hotel Company owned the El Mirador Hotel at Palm Springs, California. In July of 1932, there were $309,000.00 of First Mortgage bonds of the Palm Springs Hotel Company outstanding which were a lien upon the El Mirador Hotel property. The El Mirador Hotel was leased to the El Mirador Hotel Operating Company, which owned the furniture and fixtures in the hotel. A chattel mortgage, secured by such furniture and fixtures, was given by the lessee to Palm Springs Hotel Company as security for the performance of the terms of the lease. The lease and chattel mortgage were pledged by Palm Springs Hotel Company as part of the security for its bond issue. [45]

The taxpayer, the Palm Springs Holding Corporation, was incorporated under the laws of the State of California, on April 1, 1932, and during the month of May, 1932, issued all its capital stock in exchange for $292,000.00 par value of said bonds of the Palm Springs Hotel Company. The taxpayer was formed for the purpose of acquiring the said bonds and ultimately the properties of the Palm Springs Hotel Company and of the El Mirador Hotel Operating Company.

On July 15, 1932, the Trustee sold all of the property securing the bond issue, including the above mentioned lease and chattel mortgage, to the taxpayer, who was the highest bidder; the bid price was $61,800.00, which was paid as follows: Cash $18,767.96; $292,000.00 par value of bonds for the balance of the bid price, to wit: $43,032.04.

Thereafter and on August 2, 1932, the taxpayer foreclosed the chattel mortgage on the furniture and fixtures. Said furniture and fixtures were sold to the taxpayer by the Sheriff pursuant to the foreclosure for a bid price of $20,179.25. The amount of the judgment for indebtedness of the El Mirador Hotel Operating Company under the lease and chattel mortgage was $77,918.79. The said furniture and fixtures constituted all of the properties of the El Mirador Hotel Operating Company. The Commissioner based his determination of the depreciation upon the furniture and fixtures upon what he claimed to be the fair market value thereof as of the [46] date of foreclosure of the chattel mortgage.

In its return for the fiscal year ended May 31, 1936, the taxpayer claimed depreciation on furniture and fixtures in the sum of $32,083.57, based upon the cost to the El Mirador Hotel Operating Company plus subsequent improvements. The cost to the El Mirador Hotel Operating Company of the furniture and fixtures acquired by the taxpayer on August 2, 1932, as aforesaid, including all additions up to date, was $232,544.10. Subsequently the taxpayer acquired additional furniture and fixtures up to May 31, 1936, at a cost of $40,485.18. The useful life of said furniture and fixtures was twelve years from the date of acquisition new.

The Commissioner in his Notice of Deficiency allowed depreciation of $15,892.97 on furniture and fixtures based on a revised cost of furniture and fixtures to May 31, 1935, $126,774.21, plus additions during taxable year, $11,334.46, or a total cost of $138,108.67. The figures used by the Commissioner were based upon valuation at date of foreclosure plus subsequent additions.

The Board of Tax Appeals decided the issue of depreciation on furniture and fixtures for the Commissioner holding that the taxpayer must use as a base for depreciation of furniture and fixtures the fair market value as of the date of the foreclosure, plus cost of additions. [47]

IV.

ASSIGNMENTS OF ERROR

The taxpayer avers that in the record and proceedings before the Board of Tax Appeals, and in the opinion and final decision rendered and entered by the said Board of Tax Appeals, manifest error occurred and intervened to the prejudice of the taxpayer, who now assigns the following errors, and each of them, which it avers occurred in said record, proceeding, opinion and final decision so rendered by the Board of Tax Appeals:

1. The Board erred in holding that for the taxable year ended May 31, 1936, there is a deficiency in the taxpayer's income tax in the amount of $3,612.78.

2. The Board erred in holding that the bondholders of the Palm Springs Holding Corporation were not stepped up to a position as stockholders in the El Mirador Hotel Operating Company and could not be considered as owners of the physical assets of that company.

3. The Board erred in holding that when the taxpayer foreclosed the chattel mortgage and purchased the furniture and fixtures its basis for that property was the same as it would be to any mortgagee acquiring property on foreclosure.

4. The Board erred in failing to find that the acquisition of the furniture and fixtures was pursuant to a plan of re-organization, and in failing to find that the El Mirador Hotel Operating Company was a party to the re-organization. [48]

5. The Board erred in failing to sustain the taxpayer's contention that it was entitled to depreciation on the basis of costs to the El Mirador Hotel Operating Co.

6. The Board erred in that the following portion of the decision is not supported by the evidence and is contrary to the law:

"That for the taxable year ended May 31, 1936, there is a deficiency in taxpayer's income tax in the amount of only $3,612.78."

Wherefore, the taxpayer petitions that the decision of the Board of Tax Appeals be reviewed by the United States Circuit Court of Appeals for the Ninth Circuit, that a transcript of the record be prepared in accordance with law and with the rules of said Court and transmitted to the Clerk of said Court for filing, and that appropriate action be taken to the end that the errors complained of be reviewed by said Court.

PALM SPRINGS HOLDING CORPORATION
By W. B. PINNEY
President

FRANK MERGENTHALER
Attorney for Petitioner:
548 South Spring Street—Room 1104
Los Angeles, California [49]

United States of America,
Southern District of California—ss.

Warren B. Pinney, being duly sworn, says that he is the President of Palm Springs Holding Corporation, the petitioner in the foregoing petition for review; that he has read the said petition and is familiar with the contents thereof; that said petition is true of his own knowledge except as to the matters therein alleged on information and belief, and as to those matters he believes it to be true.

WARREN B. PINNEY

Subscribed and sworn to before me this 15 day of August, 1940.

JESS CHENOWETH
Notary Public in and for the County of Los Angeles, State of California

My Commission expires June 3, 1943

[Endorsed]: U. S. B. T. A. Filed Aug. 22, 1940.

[50]

In the United States Circuit Court of Appeals
for the Ninth Circuit

B. T. A. Docket No. 95262

PALM SPRINGS HOLDING CORPORATION,
Petitioner on Review,

vs.

GUY T. HELVERING, Commissioner of Internal Revenue,
Respondent on Review.

NOTICE OF FILING PETITION FOR REVIEW

To: Samuel O. Clark, Jr., Esq.,
Assistant Attorney General
J. P. Wenchel, Esq.,
Chief Counsel,
Bureau of Internal Revenue
John W. Morowski, Esq.
Special Attorney,
Bureau of Internal Revenue
Attorneys for Respondent above named

You are hereby notified that Palm Springs Holding Corporation, the above named Petitioner, did on the 22d day of August, 1940, file with the Clerk of the United States Board of Tax Appeals a petition for review by the United States Circuit Court of Appeals for the Ninth Circuit of a portion of the decision of the Board heretofore rendered in the above entitled cause. A copy of the

petition for review and assignments of error as filed is hereto attached and served upon you.

Dated this 22d day of August, 1940.

FRANK MERGENTHALER
Attorney for Petitioner on Review
548 South Spring Street
Los Angeles, California

Personal service of the above and foregoing notice, together with a copy of the petition for review and assignments of error mentioned therein, is hereby acknowledged this 22d day of August, 1940.

J. P. WENCHEL
EHJ
Counsel for Respondent on Review

[Endorsed] U. S. B. T. A. Filed Aug. 22, 1940.

[51]

In the United States Circuit Court of Appeals
for the Ninth Circuit

B. T. A. No. 95262

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner on Review,

v.

PALM SPRINGS HOLDING CORPORATION,

Respondent on Review.

STATEMENT OF POINTS

Comes Now the petitioner on review herein and

makes this concise Statement of Points on which he intends to rely on the review herein, to-wit:

The United States Board of Tax Appeals erred:

1. In holding that for the taxable year ended May 31, 1936 there is a deficiency in taxpayer's income tax in the amount of only $3,612.78, and that there is no deficiency in excess-profits tax.

2. In failing to hold that there are deficiencies in come tax and excess-profits tax for the taxable year ended May 31, 1936 in the respective amounts of $6,323.54 and $940.63.

3. In holding that on authority of the cases cited by it, the taxpayer acquired the hotel buildings in question in connection with a reorganization and immediately after the transfer an interest in such property of more than 50 per centum remained in the same persons and that the taxpayer's basis of depreciation should be the same as it would have been in the hands of the Palm Springs Hotel Co., by virtue of sections 113(a)(7), 113(b) and 114(a) of the Revenue Act of 1934. [52]

4. In holding that the steps taken were obviously pursuant to and part of a plan of reorganization resulting ultimately in the acquisition by taxpayer of the assets of the Palm Springs Hotel Co., and the acquisition by the bondholders of the latter of preferred stock of the taxpayer.

5. In failing to hold that the taxpayer did not acquire its buildings in connection with a statutory reorganization and that the basis for determining

depreciation on the buildings is the cost to the taxpayer upon purchase at foreclosure sale.

6. In failing to sustain the Commissioner's determination as to depreciation allowable on buildings.

7. In that its decision is not supported by the evidence and is contrary to law.

(Signed) J. P. WENCHEL RLW
Chief Counsel,
Bureau of Internal Revenue.

Service of a copy of the above statement of points is hereby acknowledged this 19 day of August, 1940.

(Sgd) FRANK MERGENTHALER
Attorney for Respondent on Review.

JMM-pp 8-16-40

[Endorsed]: U. S. B. T. A. Filed Aug. 22, 1940.

[53]

In the United States Circuit Court of Appeals
for the Ninth Circuit

B. T. A. Docket No. 95262

PALM SPRINGS HOLDING CORPORATION,
Petitioner on Review,

vs.

GUY T. HELVERING, Commissioner of Internal Revenue

Respondent on Review.

STATEMENT OF POINTS

Comes now Palm Springs Holding Corporation, the petitioner on review herein, and makes this concise statement of points upon which it intends to rely on the review herein, to wit:

The United States Board of Tax Appeals erred:

1. In holding that for the taxable year ended May 31, 1936, there is a deficiency in the taxpayer's income tax in the amount of $3,612.78.

2. In failing to hold that the taxpayer acquired furniture and fixtures in question in connection with the re-organization.

3. In failing to hold that the taxpayer's basis for depreciation on said furniture and fixtures should be the same as it would have been in the hands of the Palm Springs Hotel Operating Company by virtue of Sections [54] 113(a)(7), 113(b) and 114(a) of the Revenue Act of 1934.

4. In failing to hold that the steps taken were pursuant to and part of the plan of re-organization

resulting ultimately in the acquisition by the taxpayer of the assets of the Palm Springs Hotel Operating Company, and the acquisition by the bondholders of the latter of preferred stock of the taxpayer.

5. In that its decision insofar as it relates to the furniture and fixtures acquired by the taxpayer is not supported by the evidence and is contrary to law.

FRANK MERGENTHALER
Attorney for Palm Springs Holding Corporation, Petitioner on Review

Service of a copy of the above statement of points is hereby acknowledged this 5th day of Sept., 1940.

(Signed) J. P. WENCHEL CAR
Attorney for Respondent on Review

[Endorsed]: U. S. B. T. A. Filed Sept. 5, 1940.

[55]

In the United States Circuit Court of Appeals for the Ninth Circuit

B. T. A. No. 95262

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner on Review,

v.

PALM SPRINGS HOLDING CORPORATION,

Respondent on Review.

DESIGNATION OF PORTIONS OF THE RECORD TO BE PRINTED

Comes now the petitioner on review herein, and complying with the rules of this Court, pertaining to the designation of the portion of the record to be printed, states that he relies upon the entire record certified by the Clerk of the Board of Tax Appeals to this Court, and directs that said record so certified be printed as the record on review.

Respectfully submitted,

(Signed) J. P. WENCHEL
RLW
Chief Counsel, Bureau of Internal Revenue.

Consented to:

(Sgd) FRANK MERGENTHALER
Attorney for Respondent.

JMM-pp 8-16-40

[Endorsed]: U. S. B. T. A. Filed Aug. 22, 1940.

[56]

In the United States Circuit Court of Appeals
for the Ninth Circuit

B. T. A. Docket No. 95262

PALM SPRINGS HOLDING CORPORATION,
Petitioner on Review,

vs.

GUY T. HELVERING, Commissioner of Internal Revenue,
Respondent on Review.

DESIGNATION OF PORTIONS OF THE RECORD TO BE PRINTED

Comes now the Palm Springs Holding Corporation, the petitioner on review herein, and complying with the rules of this Court, pertaining to the designation of the portion of the record to be printed, states that it relies upon the entire record certified by the Clerk of the Board of Tax Appeals to this Court, and directs that said record so certified be printed as the record on review.

The respondent on review has filed petition for review and designation of portions of the record to be printed, and it is the intention of the Palm Springs Holding Corporation to use said record in order to avoid duplication of same.

Respectfully submitted,
FRANK MERGENTHALER
Attorney for Palm Springs Holding Corporation, Petitioner on Review

Consented to:

(Signed) J. P. WENCHEL CAR
Attorney for Respondent on Review

[Endorsed]: U. S. B. T. A. Filed Sept. 5, 1940

[57

In the United States Circuit Court of Appeals
for the Ninth Circuit

B. T. A. No. 95262

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner on Review,

v.

PALM SPRINGS HOLDING CORPORATION

Respondent on Review.

DESIGNATION OF PORTIONS OF RECORD, PROCEEDINGS, AND EVIDENCE TO BE CONTAINED IN RECORD ON REVIEW

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, copies duly certified as correct of the following documents and records in the above-entitled cause, in connection with the peti-

tion for review by the said Circuit Court of Appeals for the Ninth Circuit, heretofore filed by the Commissioner of Internal Revenue:

1. Docket entries.
2. Pleadings:
   (a) Petition.
   (b) Answer to petition.
3. Board's memorandum findings of fact and opinion entered March 23, 1940, including Exhibits A, B, C and D attached to the stipulation of facts which is adopted by reference as the Board's findings, the stipulated facts with the exception of the exhibits being set out in the Board's findings of fact. (Photostatic copies of said Exhibits A, B, C and D will be furnished by petitioner on review to be transmitted with the certified transcript of record to the Clerk of the Court of Appeals; the photostats to be bound in the printed record at the appropriate place.) [58]
4. Board's decision entered May 25, 1940.
5. Petition for review.
6. Notices of filing petition for review.
7. Statement of points.
8. Designation of portions of the record to be printed.
9. This designation.

(Signed) J. P. WENCHEL
RLW
Chief Counsel, Bureau of Internal Revenue.

Service of a copy of the within designation of portions of record, proceedings, and evidence to be contained in record on review is hereby admitted and the portions so designated agreed to this 19 day of August, 1940.

(Sgn) FRANK MERGENTHALER
Attorney for Respondent on Review.

JMM-pp 8-16-40

[Endorsed]: U. S. B. T. A. Filed Aug. 22, 1940.

[59]

In the United States Circuit Court of Appeals for the Ninth Circuit

B. T. A. Docket No. 95262

PALM SPRINGS HOLDING CORPORATION,
Petitioner on Review,

vs.

GUY T. HELVERING, Commissioner of Internal Revenue,
Respondent on Review.

DESIGNATION OF PORTIONS OF RECORD, PROCEEDINGS AND EVIDENCE TO BE CONTAINED IN RECORD ON REVIEW

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of

Appeals for the Ninth Circuit, copies duly certified as correct of the following documents and records in the above entitled cause, in connection with the petition for review by the said Circuit Court of Appeals for the Ninth Circuit, heretofore filed by Palm Springs Holding Corporation:

1. Docket entries.
2. Pleadings:
   (a) Petition.
   (b) Answer to petition.
3. Board's memorandum findings of fact and opinion entered March 23, 1940, including Exhibits A, B, C and D attached to the stipulation of facts which is adopted by reference as the [60] Board's findings, the stipulated facts with the exception of the exhibits being set out in the Board's findings of fact. (Photostatic copies of said Exhibits A, B, C and D will be furnished by petitioner on review to be transmitted with the certified transcript of record to the Clerk of the Court of Appeals; the photostats to be bound in the printed record at the appropriate place.)
4. Board's decision entered May 25, 1940.
5. Petition for review.
6. Notices of filing petition for review.
7. Statement of points.
8. Designation of portions of the record to be printed.
9. This designation.

The Commissioner of Internal Revenue has heretofore also filed a petition for review in the above

matter and has designated portions of the record, proceedings and evidence to be contained in the record on review. In order to avoid duplication it is the intention of Palm Springs Holding Corporation to use the same record.

FRANK MERGENTHALER
Attorney for Palm Springs Holding Corporation, Petitioner on Review

Service of a copy of the within designation of portions of record, proceedings, and evidence to be contained in record on review is hereby admitted and the portions so designated agreed to this 5th day of Sept., 1940.

(Signed) J. P. WENCHEL CAR
Attorney for Respondent on Review

[Endorsed]: U. S. B. T. A. Filed Sept. 5, 1940.

[61]

In the United States Circuit Court of Appeals
for the Ninth Circuit

B. T. A. Docket No. 95262

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner on Review,

v.

PALM SPRINGS HOLDING CORPORATION,

Respondent on Review.

PALM SPRINGS HOLDING CORPORATION,

Petitioner on Review,

v.

GUY T. HELVERING, Commissioner of Internal Revenue,

Respondent on Review.

ORDER

Upon consideration of the joint motion filed herein by counsel for the parties in the above-entitled proceedings, it is hereby ordered:

1. That the above-entitled proceedings be and they are hereby ordered consolidated for briefing, hearing, argument, and decision upon a single consolidated transcript of record, consisting of such portions of the record made before the United States Board of Tax Appeals as the parties herein may indicate by their designations, omitting any repetition of documents.

2. That the cost of the printing of the consolidated record on review be borne one-half by each of the petitioners on review.

And it is further ordered that the Clerk of this Court transmit to the Clerk of the United States Board of Tax Appeals a certified copy of this order to be by him incorporated in the record on review as certified and transmitted by him to this Court.

By the Court

(s) CURTIS D. WILBUR
Judge, U. S. Circuit Court of Appeals.

Dated: San Francisco, Calif.

[Endorsed]: Filed: September 13, 1940. Paul P. O'Brien, Clerk.

A true copy:

Attest: September 14, 1940.
PAUL P. O'BRIEN,
Clerk
By FRANK H. SCHMID
Deputy

[Endorsed]: U. S. B. T. A. Filed Sept. 16, 1940.

[62]

[Title of Board and Cause.]

CERTIFICATE

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 62, inclusive, contain and are a true copy of the

transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 27th day of September, 1940.

B. D. GAMBLE
Clerk, United States Board of
Tax Appeals.

EXHIBIT A

Bondholders' Protective Agreement

PALM SPRINGS HOTEL COMPANY

First Mortgage Seven Percent Sinking Fund Gold Bonds

THIS AGREEMENT, made and entered into as of the 20th day of August, 1931, by and between A. R. LEROY and E. A. GRUMM, residing in the County of Los Angeles, California, and RALPH D. LACOE, JR. residing in the County of San Diego, California, as Parties of the First Part, hereby appointed a Bondholders' Protective Committee for the purposes described in this agreement, and herein, together with their successors, designated for convenience as the "Committee" and such holders of the First Mortgage Seven Per Cent Sinking Fund Gold Bonds of Palm Springs Hotel Company, a Nevada corporation, as shall become parties to this agreement in the manner herein provided (which Parties and their respective transferees are herein referred to as the Depositing Bondholders) Parties of the Second Part.

WITNESSETH:

THAT, WHEREAS, said Palm Springs Hotel Company (hereinafter called the "Company") has heretofore executed and delivered to California Trust Company (hereinafter called the "Trustee") a certain Trust Indenture dated as of June 15, 1927 and a supplemental Trust Indenture dated as of June 15th, 1928 (said Trust Indentures being hereinafter referred to as "Indenture"), securing the payment of $325,000.00 principal amount of its First Mortgage Seven Per Cent Sinking Fund Gold Bonds (of which there are now unredeemed and outstanding $309,000.00 in principal amount thereof hereinafter called "Bonds") and

WHEREAS, the Company is now in default in the performance of certain of the covenants contained in said Indenture and said Bonds and it is the desire of the Committee and of the depositing bondholders to provide a means whereby the Company may be able to perform its obligations under said Indenture and Bonds as they now exist or as they may be modified and extended to the extent as hereinafter provided and/or if necessary for refinancing and/or reorganization of the Company and/or for the foreclosure of said Indenture and/or the sale of property covered thereby as provided in said Indenture.

NOW, THEREFORE, in consideration of the deposit of bonds as herein provided and in further consideration of the services to be performed by the Committee and of the advantages which will accrue to the Depositing Bondholders from union of interest and concerted action,

IT IS MUTUALLY AGREED AS FOLLOWS: to-wit:

I.

Any holder of said bonds issued under and secured by said Indenture, may become a party to this agreement by depositing the said bonds held by him in negotiable form together with the interest coupons attached thereto and maturing June 15, 1931 and subsequent thereto, with CALIFORNIA TRUST COMPANY, a corporation, (hereinafter referred to as the Depositary) at its head office in the City of Los Angeles, California, within sixty days from the date of this agreement or such further time as the Committee may from time to time determine. Upon the deposit of any such bonds with the Depositary as aforesaid, a certificate of deposit shall be issued by the depositary, in substantially the following form:

No. Principal Amount $

CERTIFICATE OF DEPOSIT
of
PALM SPRINGS HOTEL COMPANY
First Mortgage Seven Per Cent Sinking Fund Gold Bonds

THIS CERTIFIES that has deposited with CALIFORNIA TRUST COMPANY (hereinafter called the Depositary) at its head office in the City of Los Angeles, California, ($)

Dollars

aggregate principal face amount of the First Mortgage Seven Per Cent Sinking Fund Gold Bonds of the Palm Springs Hotel Company, a Nevada corporation, issued under that certain mortgage or deed of trust dated as of June 15th, 1927 and/or that certain supplemental mortgage or deed of trust dated as of June 15th, 1928 executed by said Palm Springs Hotel Company, a Nevada corporation, to California Trust Company, as Trustee.

There is also deposited with each bond the coupon appertaining thereto due June 15, 1931, and all such coupons due thereafter. Such securities are deposited and received and this certificate is issued subject to and for the purposes and uses specified in an agreement dated as of the 20th day of August, 1931, and now on file in the said head office of the Depositary between the holders of said bonds depositing same thereunder and A. R. LEROY, E. A. GRUMM and RALPH D. LACOE, JR. as a protective committee subject to the sole control, direction and disposition of said Committee and its successors. The Depositor herein named and each successive holder of this certificate by acceptance hereof, approves and becomes a party to and bound by said agreement to which, as to the whole and each and all of the terms and conditions thereof, reference is hereby expressly made.

This certificate is transferable only on the books of the Depositary under said agreement, upon surrender hereof to it at its head office, duly assigned, and the Depositary shall not be bound to take notice of or be affected by any trust respecting the title or ownership of this certificate or the bonds and/or coupons represented thereby.

Dated at Los Angeles, California, , 1931.

CALIFORNIA TRUST COMPANY, Depositary

Any holder of said bonds issued under and secured by said Indenture, may become a party to this agreement by depositing the said bonds held by him in negotiable form together with the interest coupons attached thereto and maturing June 15, 1931 and subsequent thereto, with CALIFORNIA TRUST COMPANY, a corporation, (hereinafter referred to as the Depositary) at its head office in the City of Los Angeles, California, within sixty days from the date of this agreement or such further time as the Committee may from time to time determine. Upon the deposit of any such bonds with the Depositary as aforesaid, a certificate of deposit shall be issued by the Depositary, in substantially the following form:

No. Principal Amount $

CERTIFICATE OF DEPOSIT
of
PALM SPRINGS HOTEL COMPANY
First Mortgage Seven Per Cent Sinking Fund Gold Bonds

THIS CERTIFIES that has deposited with CALIFORNIA TRUST COMPANY (hereinafter called the Depositary) at its head office in the City of Los Angeles, California, ($)

Dollars

aggregate principal face amount of the First Mortgage Seven Per Cent Sinking Fund Gold Bonds of the Palm Springs Hotel Company, a Nevada corporation, issued under that certain mortgage or deed of trust dated as of June 15th, 1927 and or that certain supplemental mortgage or deed of trust dated as of June 15th, 1928 executed by said Palm Springs Hotel Company, a Nevada corporation, to California Trust Company, as Trustee.

There is also deposited with each bond the coupon appertaining thereto, due June 15, 1931, and all such coupons due thereafter. Said securities are deposited and received and this certificate is issued subject to and for the purposes and uses specified in an agreement dated as of the 20th day of August, 1931, and now on file in the said head office of the Depositary between the holders of said bonds depositing same thereunder and A. R. LEROY, E. A. GRUMM and RALPH D. LACOE, JR. as a protective committee subject to the sole control, direction and disposition of said Committee and its successors. The Depositor herein named and each successive holder of this certificate by acceptance hereof, approves and becomes a party to and bound by said agreement to which, as to the whole and each and all of the terms and conditions thereof, reference is hereby expressly made.

This certificate is transferable only on the books of the Depositary under said agreement, upon surrender hereof to it at its head office, duly assigned, and the Depositary shall not be bound to take notice of or be affected by any trust respecting the title or ownership of this certificate or the bonds and/or coupons represented thereby.

Dated at Los Angeles, California, , 1931.

CALIFORNIA TRUST COMPANY, Depositary

By

Authorized Officer.

(Reverse Side of Certificate)

FOR VALUE RECEIVED

hereby sell, transfer and assign to

whose address is

subject to the terms and conditions of the herein mentioned agreement, all right, title and interest in and to the herein described bonds, together with all of the benefits and advantages to which may be entitled thereunder and growing out of said agreement.

, 1931.

After any such deposit no separate action shall be taken by a Depositing Bondholder with respect to the bonds and or coupons so deposited. It is the intent and purpose of this agreement, and therefore hereby agreed, by and between the Depositing Bondholders and the Committee, that all bonds and/or coupons so deposited hereunder shall (except as herein otherwise provided) be held by the Depositary until, in the judgment of the Committee, there shall no longer be any necessity for any action by the Committee that may be

authorized hereunder, in which event the Depositing Bondholders shall be entitled to the delivery of the bonds and/or coupons severally deposited by them, as provided in Article XI hereof. The deposit of the bonds and, coupons and/or the acceptance of a certificate of deposit therefor shall have the same force and effect as though the depositing bondholder had been named in and had subscribed to this agreement. The certificates of deposit may be transferred by delivery thereof, properly endorsed, but no such transfer shall be effectual unless registered in the office of the Depositary. Upon the transfer of any certificate of deposit, the transferee (after entry of such transfer on the records of the Depositary) shall for all purposes be substituted for the prior holder of such certificate of deposit and the registered holders for the time being of the respective certificates of deposit may be treated as the absolute owners thereof and entitled to all rights of the original Depositing Bondholders. Each Depositing Bondholder shall file with the Depositary his address at which notices may be directed to him.

II.

To the end that the Committee may be able to protect and promote the interests of the Depositing Bondholders, the Committee is hereby vested under the terms of this agreement as trustees of an express trust with legal title to and ownership of all the bonds and coupons deposited hereunder, and the Depositing Bondholders hereby, for the consideration aforesaid, and each also in consideration of the assignment and transfer to the Committee of the bonds and coupons of the Depositing Bondholders respectively by them hereunder, does hereby transfer and assign all of his right, title and interest in and to said bonds and coupons deposited by him hereunder to the Committee, and no limitation is imposed on the powers of the Committee as the legal owner except the duty of doing whatever is calculated in its opinion to promote the interests of the Depositing Bondholders without preference or priority of any of them over any other of them, and the Committee hereby assumes such duty.

The Depositing Bondholders hereby further irrevocably constitute and appoint the Committee their attorneys in fact and the attorneys in fact of each of them, and hereby authorize and empower the Committee in the name of and on behalf of the Depositing Bondholders, to institute, intervene in and defend such legal proceedings, and to file such protests, consents or other instruments necessary, convenient or requisite in connection with any remedies provided for in the deed of trust in the event of a default by the Company as may in the judgment of the Committee protect the interests of the Depositing Bondholders, and to take any other action, step, or proceeding to enforce any director's, officer's and/or stockholder's liability under the provisions of the statutes and constitution of the State of California, and to do, take and perform any other act, proceeding or thing which the Depositing Bondholders themselves, or any of them, might or could do if this agreement had not been made.

The Depositing Bondholders will at the request of the Committee execute such further instruments as shall be convenient and proper to make most effective the foregoing assignment and appointment.

III.

Without hereby limiting the general powers vested in it, the Committee is specifically authorized, in its discretion to purchase any or all of the property which constitutes the security for said bonds, for the account of the Depositing Bondholders on any terms which the Committee accepts; to apply the deposited bonds and coupons, or any of them, in satisfaction of any bid or purchase price in the event of foreclosure sale or Trustee's sale of the secured property; to sell, pledge, mortgage, hypothecate, transfer, and/or assign or otherwise dispose of all or any of the said bonds and coupons and real and personal property purchased or acquired by or on behalf of the Committee, for the purpose of borrowing or raising funds necessary in the judgment of the Committee to be borrowed or raised to carry out the trusts hereby assumed or for any other purpose to serve the interests of the Depositing Bondholders; to expend the moneys so realized for such purposes as in its uncontrolled discretion it deems to be for the best interests of the Depositing Bondholders, including the loaning or advancing of money to the company either with or without security and the repayment to CALIFORNIA TRUST COMPANY, Trustee, of any indebtedness incurred by it (whether before or after the execution hereof) in carrying out any of the trusts of said indenture or this agreement or any directions of the Committee, with legal interest on each such advance or expenditure from the date thereof until such reimbursement; as well as the compensation of said Trustee; to sell for cash or on terms or to exchange any property purchased at foreclosure sale or Trustee's sale or otherwise in behalf of and in trust for the Depositing Bondholders, and to accept cash, mortgage interests in land, improved or unimproved, and shares of stocks, bonds, securities, notes and other personal property in payment of all or any part of the purchase price; to sell or otherwise dispose of the deposited bonds and coupons; to take possession or control of and operate all or any of the mortgaged property to be transferred and conveyed to any bank and/or trust company authorized to conduct a trust business in the State of California in trust for the Depositing Bondholders in proportion to their respective interests, which trust shall be for such purposes, in such form, for such period of time and upon such terms and conditions as the Committee in its sole discretion shall deem advisable, with power to borrow such sum or sums of money secured by the terms of any such trust from time to time as may be necessary in the judgment of the Committee to be raised to fully carry out the purposes and terms of this agreement, and each Depositing Bondholder by becoming a party hereto in the manner herein set forth does hereby confirm and approve any such declaration of trust and each and all of the terms, covenants, provisions and conditions that may be therein contained and set forth.

IV.

No member of the Committee and any firm, association or corporation of which he may be a member, officer, director or stockholder, the Depositary above named and any officer, director or stockholder of the Company may become pecuniarily interested in any property, matters which are or may become the subject of this agreement, and may contract with the Committee with reference to any of such property, matters, the Depositing Bondholders hereby consenting thereto.

V.

The Committee may limit or extend the time within which bonds may be deposited under this agreement, and no bondholder failing to deposit his bonds within the time limited by the Committee, shall have any right to become a party to this agreement without the express written consent of the Committee. Neither the Committee nor any of its members shall be personally liable for any act or omission in accordance with the advice of counsel, attorney or agent selected in good faith, nor for any error of judgment, nor mistake of fact or law, nor upon any agreement or other instrument signed or entered into by the Committee or authorized by it. No member of the Committee shall be liable for the acts, default or defaults, of any other member, nor for anything but his own individual wilful misconduct. The Committee

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Without hereby limiting the general powers vested in it, the Committee is specifically authorized, in its discretion to purchase any or all of the property which constitutes the security for said bonds, for the account of the Depositing Bondholders on any terms which the Committee accepts; to apply the deposited bonds and coupons, or any of them, in satisfaction of any bid or purchase price in the event of foreclosure sale or Trustee's sale of the secured property; to sell, pledge, mortgage, hypothecate, transfer, and/or assign or otherwise dispose of all or any of the said bonds and coupons and real and personal property purchased or acquired by or on behalf of the Committee, for the purpose of borrowing or raising funds necessary in the judgment of the Committee to be borrowed or raised to carry out the trusts hereby assumed or for any other purpose to serve the interests of the Depositing Bondholders; to expend the moneys so realized for such purposes as in its uncontrolled discretion it deems to be for the best interests of the Depositing Bondholders, including the loaning or advancing of money to the company either with or without security and the repayment to CALIFORNIA TRUST COMPANY, Trustee, of any indebtedness incurred by it (whether before or after the execution hereof) in carrying out any of the trusts of said indenture or this agreement or any directions of the Committee, with legal interest on each such advance or expenditure from the date thereof until such reimbursement, as well as the compensation of said Trustee; to sell for cash or on terms or to exchange any property purchased at foreclosure sale or Trustee's sale or otherwise in behalf of and in trust for the Depositing Bondholders, and to accept cash, land or interests in land, improved or unimproved, and shares of stocks, bonds, securities, notes and other personal property in payment of all or any part of the purchase price; to sell or otherwise dispose of the deposited bonds and coupons; to take possession or control of and operate all or any of the mortgaged property to be transferred and conveyed to any bank and/or trust company authorized to conduct a trust business in the State of California in trust for the Depositing Bondholders in proportion to their respective interests, which trust shall be for such purposes, in such form, for such period of time and upon such terms and conditions as the Committee in their sole discretion shall deem advisable, with power to borrow such sum or sums of money secured by the terms of any such trust from time to time as may be necessary in the judgment of the Committee to be raised to fully carry out the purposes and terms of this agreement, and each Depositing Bondholder by becoming a party hereto in the manner herein set forth does hereby confirm and approve any such declaration of trust and each and all of the terms, covenants, provisions and conditions that may be therein contained and set forth.

IV.

Any member of the Committee and any firm, association or corporation of which he may be a member, officer, director or stockholder, and the Depositary above named and any officer, director or stockholder of the Company may become pecuniarily interested in any property or matters which are or may become the subject of this agreement, and may contract with the Committee with reference to any of the said matters, the Depositing Bondholders hereby consenting thereto.

V.

The Committee may limit or extend the time within which bonds may be deposited under this agreement, and no bondholder failing to deposit his bonds within the time limited by the Committee, shall have any right to become a party to this agreement without the express written consent of the Committee. Neither the Committee nor any of its members shall be personally liable for any act or omission of any counsel, attorney or agent selected in good faith, nor for any error of judgment, nor mistake of fact or law, nor upon any agreement, note or other instrument signed or entered into by the Committee or authorized by it. No member of the Committee shall be liable for the act or acts, default or defaults, of any other member, nor for anything but his own individual wilful misconduct. The Committee shall not be under any obligation, legal or equitable, expressed or implied, to any bondholder who shall not deposit his bonds hereunder, or to any other person whomsoever other than the holders of the Certificates of Deposit issued in accordance with the terms hereof.

VI.

The Committee shall have the power

(a) to adopt or approve any plan for the readjustment of the property of the Company covered by said deed of trust with or without foreclosure and sale, or for the continuance of the existing bonds and security with any alteration or modification thereof accepted by the Committee, and to change or modify or add to or eliminate any of the provisions of the trust indenture securing said bonds. Any such plan may provide for the acquisition of other property; for the organization of a new corporation or corporations; for the issue and distribution of shares of stocks, bonds, securities, notes and/or other personal property, and for the raising of any sums in cash deemed necessary by the Committee.

(b) To exchange said bonds for other obligations of the Company similar or dissimilar to said bonds and in accordance with or separate from any plan of reorganization which the Committee may hereafter, on behalf of the Depositing Bondholder, approve or adopt; to cancel and acknowledge payment of said bonds and/or authorize the Trustee under said Indenture to reconvey the property thereby conveyed to it upon such terms and for such considerations as the Committee may deem proper, including specifically therein the execution of a new obligation or obligations and the conveyance of any property to the Trustee under a new, amended or different Indenture, mortgage or deed of trust;

(c) To make, execute, enter into, assent to and deliver any and all instruments and documents including conveyance, reconveyances, agreements and subscriptions for bonds which may be necessary or desirable in the opinion of the Committee to accomplish, carry out and complete the provisions of this agreement and to protect the rights of the Depositing Bondholders and the security in the hands of the Trustee for the performance of the Company's obligations;

(d) To designate and appoint one or more depositaries and/or escrow-holders for convenience in the performance of the provisions

of this agreement, and to instruct and authorize said depositaries, and/or escrow-holders to act and perform in their respective capacities, to such extent as the Committee may deem necessary;

(e) To receive sums of money from the Company, or otherwise, for or on account of the obligations due to the Depositing Bondholders, and to disburse, distribute and otherwise deal in and with any and all sums so received in such manner as the Committee may deem most desirable for the protection of the interests of the Depositing Bondholders hereunder; to receive from the Trustee and to give acquittance for any money or property received or held by the Trustee under the provisions of said Indenture and to generally deal in and with any such money or property;

(f) To cause corporations to be formed under such laws and upon such plans and with such powers as the Committee may deem advisable; to cause said corporations to take such proceedings as may be in the opinion of the Committee requisite or desirable, and to represent the Depositing Bondholders in the formation and organization of said corporations and in the performance of their respective corporate functions, including the issuance of shares of stock, bonds, securities, notes and/or personal property thereby, all in order to accomplish, carry out and complete the terms of this agreement;

(g) To employ such agents, attorneys, accountants or advisors as may be necessary in connection with the transactions herein outlined and the performance of the provisions of this agreement, and to pay such compensation as the Committee may deem reasonable to any such person, firms or corporations so employed.

VII.

Upon the completion of any sale, readjustment, reorganization or other arrangement which the Committee considers to be the final accomplishment of the purpose of this agreement, or upon the termination of this agreement, the Committee shall hold all the resultant cash, securities, assets and property (subject to the payment of the expenses and liabilities of the Committee) to distribute the same among the Depositing Bondholders pro rata on the principal amount of their bonds deposited hereunder and for the purpose of such distribution the Committee shall have a discretionary power to sell all or any of the said securities, assets and property.

VIII.

For the purpose of borrowing or raising any moneys, in the judgment of the Committee, required by it, or of furnishing indemnity to the Trustee, or of furthering any of the trusts hereby created, the Committee is hereby authorized and empowered to pledge, mortgage, hypothecate, or assign all or any of the deposited bonds and/or coupons, securities and any other property, real or personal, which may come into the possession or control of the Committee, with such provisions in the loan or indemnity agreement as the lender of the money or the trustee may exact and the Committee shall approve.

IX.

The Depositing Bondholders shall not be personally liable to the Committee, or to any other person, persons, or corporations, for any sum of money or for or in respect of any acts of the Committee, but the Committee and/or the Depositary shall have a first lien (subject however to any lien or liens thereon created by the Committee) upon the deposited bonds and/or coupons and all other securities and property, real or personal, acquired by it, for the reimbursement of all expenses, fees, indebtedness and/or liability incurred by or payable to either of them in acting under this agreement, and said lien shall not be dependent upon possession of said bonds or coupons or other property by the Committee, or the Depositary, who may enforce such lien by a sale, either public or private, of all or any of the property subject thereto, whether real or personal, and without demand upon or notice to any of the depositing bondholders, or any other person or persons whomsoever.

X.

The Committee may, in its discretion, act by or through agents, attorneys or legal counsel.

XI.

If for any reason the Committee shall consider it expedient at any time to terminate this agreement, it may do so by giving notice thereof through the mails registered and postage prepaid, to the holders of Certificates of Deposit, at the addresses of the said holders filed with the Depositary provided, however, that this agreement and any trust created hereby shall in any event cease and terminate as of July 1, 1936. In the event of such termination of this agreement prior to a sale or other disposition of the deposited bonds and/or coupons, the holders of the Certificates of Deposit shall surrender to the Depositary their said certificates properly endorsed in blank, and shall thereupon be entitled to the delivery of the bonds and/or coupons severally deposited by them upon payment pro rata of all expenses, indebtedness and/or liabilities of the Committee, provided, however, that if the Depositary shall have previously delivered any of such bonds and/or coupons to the Committee, it shall not be liable to the depositor for the delivery of such bonds and/or coupons.

XII.

The Depositary shall deliver said bonds and coupons, or any thereof, to the Committee on order of the Committee and the receipt of the Committee shall be a sufficient acquittance therefor to said Depositary. The Depositary shall hold and deal with the deposited bonds and coupons subject to and in accordance with the orders of the Committee and shall be entitled to receive reasonable compensation for its services hereunder. The depositary shall not incur any liability for anything done or permitted to be done at the request or direction of the Committee and shall not be liable for the acts of any agent selected in good faith, nor for anything except its own wilful misconduct. The Depositary shall not be liable for any action taken in good faith in the belief that the depositor of any bond or coupons is the lawful owner and holder thereof or of the certificate of deposit representing the same. The Depositary shall be bound only to exercise reasonable care in the safekeeping of the deposited bonds, coupons, certificates of deposit, and other securities and property which may be deposited with or held by it hereunder and to deal therewith in accordance with the directions of the Committee. The Depositary may resign by giving written notice of such resignation to the Committee at least ten (10) days before such resignation becomes effective. The Depositary may at any time be removed by the Committee and upon such removal the Committee shall have power to appoint a new Depositary hereunder. In the event of any such resignation or removal the Depositary shall, upon receiving due and proper receipt and acquittance and payment of all sums due it hereunder, deliver all cash, securities, property and records held by it to the new Depositary.

XIII.

A writing signed by a majority of the Committee then in office, or a resolution certified by the Secretary of the said Committee, or any member thereof, to have been adopted by a majority of the Committee then in office, a copy of which shall be sufficient evidence

among the Depositing Bondholders pro rata to the principal amount of their bonds deposited hereunder and for the purpose of such distribution the Committee shall have a discretionary power to sell all or any of the said securities, assets and property.

VIII.

For the purpose of borrowing or raising any moneys, in the judgment of the Committee, required by it, or of furnishing indemnity to the Trustee, or of furthering any of the trusts hereby created, the Committee is hereby authorized and empowered to pledge, mortgage, hypothecate, or assign all or any of the deposited bonds and/or coupons, securities and any other property, real or personal, which may come into the possession or control of the Committee, with such provisions in the loan or indemnity agreement as the lender of the money or the trustee may exact and the Committee shall approve.

IX.

The Depositing Bondholders shall not be personally liable to the Committee, or to any other person, persons, or corporations, for any sum of money or for or in respect of any acts of the Committee, but the Committee and/or the Depositary shall have a first lien (subject however to any lien or liens thereon created by the Committee) upon the deposited bonds and/or coupons and all other securities and property, real or personal, acquired by it, for the reimbursement of all expenses, fees, indebtedness and/or liability incurred by or payable to either of them in acting under this agreement, and said lien shall not be dependent upon possession of said bonds or coupons or other property by the Committee, or the Depositary, who may enforce such lien by a sale, either public or private, of all or any of the property subject thereto, whether real or personal, and without demand upon or notice to any of the depositing bondholders, or any other person or persons whomsoever.

X.

The Committee may, in its discretion, act by or through agents, attorneys or legal counsel.

XI.

If for any reason the Committee shall consider it expedient at any time to terminate this agreement, it may do so by giving notice thereof through the mails registered and postage prepaid, to the holders of Certificates of Deposit, at the addresses of the said holders filed with the Depositary provided, however, that this agreement and any trust created hereby shall in any event cease and terminate as of July 1, 1936. In the event of such termination of this agreement prior to a sale or other disposition of the deposited bonds and/or coupons, the holders of the Certificates of Deposit shall surrender to the Depositary their said certificates properly endorsed in blank, and shall thereupon be entitled to the delivery of the bonds and/or coupons severally deposited by them upon payment pro rata of all expenses, indebtedness and/or liabilities of the Committee, provided, however, that if the Depositary shall have previously delivered any of such bonds and/or coupons to the Committee, it shall not be liable to the depositor for the delivery of such bonds and/or coupons.

XII.

The Depositary shall deliver said bonds and coupons, or any thereof, to the Committee on order of the Committee and the receipt of the Committee shall be a sufficient acquittance therefor to said Depositary. The Depositary shall hold and deal with the deposited bonds and/or coupons subject to and in accordance with the orders of the Committee and shall be entitled to receive reasonable compensation for its services hereunder. The depositary shall not incur any liability for anything done or permitted to be done at the request or direction of the Committee and shall not be liable for the acts of any agent selected in good faith, nor for anything except its own wilful misconduct. The Depositary shall not be liable for any action taken in good faith in the belief that the depositor of any bond or coupons is the lawful owner and holder thereof or of the certificate of deposit representing the same. The Depositary shall be bound only to exercise reasonable care in the safekeeping of the deposited bonds, coupons, certificates of deposit, and other securities and property which may be deposited with or held by it hereunder and to deal therewith in accordance with the directions of the Committee. The Depositary may resign by giving written notice of such resignation to the Committee at least ten (10) days before such resignation becomes effective. The Depositary may at any time be removed by the Committee and upon such removal the Committee shall have power to appoint a new Depositary hereunder. In the event of any such resignation or removal the Depositary shall, upon receiving due and proper receipt and acquittance and payment of all sums due it hereunder, deliver all cash, securities, property and records held by it to the new Depositary.

XIII.

A writing signed by a majority of the Committee then in office, or a resolution certified by the Secretary of the said Committee, or any member thereof, to have been adopted by a majority of the Committee then in office at any meeting thereof shall be sufficient evidence of any facts, or of any action of the Committee stated therein, to the Depositary and as against all parties in interest.

XIV.

Any member of the Committee may at any time resign by filing a written resignation with the said Committee and said resignation shall take effect in accordance with its terms.

The Committee shall organize and continue its organization during the period that it shall function under the provisions of this agreement by choosing a Chairman who shall be a member of the Committee and a Secretary who need not be a member of the Committee. Meetings of the Committee shall be held at the office of the Los Angeles Investment Securities Corporation, 1035 South Broadway, Los Angeles, California, or at such other place as may be consented to in writing or by telegraph by all of the members of the Committee, or at which all the members of the Committee may be present and meet as the Committee. At least three days written notice shall be given of any meeting of the Committee which notice may be given by the Chairman or Secretary depositing the same in the United States mail at Los Angeles, California, postage prepaid thereon and addressed to the members of the Committee at their respective addresses as filed with the Committee, provided, however, that no notice need be given of any meeting held by written or telegraphic consent of the members of the Committee or at which all of said members are present regardless of the time or place of the holding thereof. Any two (2) members of the Committee may and must act jointly in all matters and proceedings to be taken, had or done under the provisions hereof. In case at any time a vacancy shall occur in the membership of the Committee such vacancy shall be filled as follows: With reference to any vacancy created by the resignation, death or otherwise of A. R. LeRoy, or any of his successors

California, or its successor. With reference to any vacancy created by the resignation, death or otherwise of Ralph D. Lacoe, Jr. or any of his successors on said Committee, then such vacancy shall be filled by an appointee of Ralph D. Lacoe & Co., San Diego, California, or its successor. With reference to any vacancy created by the resignation, death or otherwise of E. A. Grumm, or any of his successors on said Committee, then such vacancy shall be filled by an appointee of the G. Brashear & Co., Los Angeles, California, or its successor.

Each such successor shall have and exercise all the powers and authorities under this agreement previously possessed by the person in whose place he shall be appointed, to the same extent and effect as if he were herein named as one of the Committee. The Committee, as at any time constituted and notwithstanding any vacancy, shall have all the title, powers, rights and interests of the Committee as originally formed, and in case of the filling of any such vacancy by such appointment, the Secretary of the Committee shall forthwith notify the Depositary of such appointment and shall certify that such appointment was regularly made. The action of a majority of the members of the Committee then in office, either at a meeting or in writing without a meeting, shall be deemed to be the action of the Committee and shall have the same force and effect as if concurred in by each of the original members of the Committee.

XV.

Any member of the Committee may, by a writing filed with the Committee, designate an alternative or proxy, and may at any time by like writing so filed, revoke any such designation and/or designate other alternative or proxy, and each alternative or proxy so designated shall have power and be permitted to act as a member of the Committee in the place and during the absence of the member making such designation, and either in his own name or in the name of such member; and all acts done, consents given and/or signatures made, by such alternative or proxy, shall have the same force and effect as if done, given and/or made by the member designating him as such alternative or proxy.

XVI.

The members of the Committee shall, and they hereby agree to serve without compensation, but this shall not be deemed to exclude the employment and compensation of a member of the Committee as legal counsel.

XVII.

Nothing in this agreement, express or implied, is intended or shall be construed to confer upon or to give to any person or corporations other than bondholders becoming parties hereto and depositing their bonds and/or coupons hereunder, any right or claim under or by reason of this agreement, and all stipulations and promises in this agreement contained, by or on behalf of the Committee, are and shall be held to be for the sole and exclusive benefit of the said parties hereto. The power and authority granted herein by the Depositing Bondholder to the Committee shall be irrevocable, and the Depositing Bondholder shall have no right, power or authority after the execution of this agreement to vary, alter, limit, or restrict the powers of the Committee in any manner or to any extent whatsoever unless and until the authority herein granted shall have terminated by the effect of the limitations and conditions herein specifically set forth.

XVIII.

The receipt of any cash, securities or other property, or certificates of interest therein, distributed by the Committee under any of the provisions of this agreement, and the surrender of his Certificate of Deposit by any Depositor, shall constitute a release and discharge of the Committee and of the Depositary by such Depositor from all liability and accountability of every kind, character and description whatsoever. The receipt by the holders of Certificates of Deposit representing a majority in amount of deposited bonds, of any cash, securities or other property or certificates of interest therein, distributed by the Committee under any of the provisions of this agreement, and the surrender of certificates of deposit representing a majority in amount of the deposited bonds shall constitute a release and discharge of the Committee and of the Depositary on the part of the holders of all outstanding Certificates of Deposit from all liability and accountability of every kind, character and description whatsoever, save the obligation to make delivery of a like pro rata amount of such securities, or other property or certificates of interest therein upon the surrender of outstanding certificates of deposit.

XIX.

The Committee shall have the right and power to levy and collect assessments against the depositing bondholders proportionately with the amount of the bonds deposited hereunder, from time to time and in such sums and amounts as the Committee deem advisable for the proper protection of the bondholders and the rights and interests of the bondholders. Any money so paid in by a depositing bondholder shall be repaid to the bondholders respectively who shall have paid said assessments, together with interest thereon at the rate of Six Per Cent (6%) per annum from the date of payment of said assessments, before any payment or distribution shall be made to bondholders who shall be entitled to distribution of bonds, property or proceeds in the hands of the Committee at the time of termination of this agreement, or prior thereto if partial distribution is to be made. And the Committee shall have full right and authority to sell any property of any kind in its possession in order to realize sufficient moneys to repay the bondholders who shall have paid said assessments.

XX.

The failure of any bondholder owning any bonds and/or coupons hereunder to deliver said bonds and/or coupons to the depositary shall not affect the right of the Committee to proceed to accomplish and carry out the provisions of this agreement in so far as it is able to do by the Depositing Bondholders, it being the intent and purpose hereof that the obligations and delegations of duties herein contained are several as to each of the Depositing Bondholders and not joint on the part of all or any portion of the Bondholders of the Company.

XXI.

Copies of this agreement, signed by each member of the Committee, shall be lodged with the Depositary. This agreement shall become effective when signed by a majority of the members of the Committee. This agreement, however, may be executed in any number

INCORPORATED UNDER THE LAWS OF THE STATE OF CALIFORNIA, 1924

NUMBER 206

SHARES 0

PALM SPRINGS HOLDING CORPORATION

CAPITAL STOCK 10,500 SHARES

3,000 SHARES PREFERRED STOCK
$100 PAR VALUE

7,500 SHARES COMMON STOCK
NO PAR VALUE

SAMPLE

PREFERRED

THIS CERTIFIES that _____ *is the owner of*

_____ *shares of the Preferred Capital Stock of PALM SPRINGS HOLDING CORPORATION transferable only on the books of the Corporation by the holder thereof in person or by Attorney, upon surrender of this Certificate properly endorsed.*

The preferences, privileges and restrictions granted to or imposed upon the respective classes of shares and the holders thereof are as follows:

The holders of record of the preferred shares shall be entitled to receive for any calendar year, when and as declared by the board of directors of the corporation, from the surplus or net profits earned during such calendar year, dividends at the rate of six per cent (6%) per annum, of the par value of such shares, and no more, payable yearly, half yearly or quarterly as the board of directors from time to time may determine. The right to such dividends on preferred shares shall not be cumulative and no right shall accrue to the holders of preferred shares by reason of the fact that dividends on said shares are not declared or paid in any calendar year, but that all payment of all amounts payable during such calendar year on account of fixed charges, taxes, insurance, repairs, general upkeep, reserves, operating expenses, charges, interest, sinking fund and/or principal of any and all debts and/or liabilities of the corporation, after the deduction for depreciation in the sum of fifteen thousand dollars ($15,000) any net profits of the corporation earned during such calendar year remain, it shall be the duty of the directors to declare and cause to be paid to the holders of record of preferred shares, dividends in an amount equal to the aggregate amount of such net profits, but in no event in an amount in excess of the amount equal to six per cent (6%) of the par value of such shares, which dividends shall be payable yearly, half-yearly or quarterly as the directors may determine. No dividends shall be paid upon any of the common shares for any calendar year out of the surplus or net profits earned during such calendar year, unless all dividends thereon declared for the preferred shares previously accrued shall be paid. Upon any liquidation or dissolution or winding-up of the corporation, the holders of the preferred shares shall be entitled to be paid out of the assets of the corporation or the proceeds thereof, before any amount shall be paid to the holders of the common shares, an amount equal to the par value of said preferred shares, whether such liquidation or dissolution or winding-up be voluntary or involuntary, and in addition an amount equal to the aggregate amount of all unpaid dividends declared thereon. Upon such notice to the record owners of the preferred shares as may be provided for by the directors, the corporation, at its election, expressed by resolution of the board of directors, may redeem all or any of the preferred shares, by lot or otherwise as the directors may determine, at the time specified in the resolution of the directors and in such notice, at a price (herein called the "redemption price") equal to one hundred six per cent (106%) of the par value thereof, and in addition an amount equal to the aggregate amount of all unpaid dividends declared thereon, all by such method as shall be provided from time to time by resolution of the board of directors of the corporation. From and after the date fixed in any such notice as the date of redemption, unless default be made by the corporation in providing money at the time and place specified for the payment of the redemption price pursuant to such notice, all dividends on the preferred shares thereby called for redemption shall cease to accrue and all rights of the holders thereof as shareholders of the corporation, except the right to receive the redemption price, shall cease and determine. Every holder of preferred shares of the corporation, by the acceptance of the issuance or transfer of such shares, shall be deemed to confent to the purchase or redemption or retirement of such shares as herein provided.

Except as to the matters and things so stated, no distinction shall exist between said classes of shares or the holders thereof.

IN WITNESS WHEREOF, the duly authorized officers of this Corporation have hereunto subscribed their names and caused the corporate seal to be hereto affixed this _____ *day of* _____, *A. D. 19*____

For value Received hereby sell assign and transfer unto

_____

Shares of the Capital Stock represented by the within Certificate and do hereby irrevocably constitute and appoint _____ Attorney to transfer the said Stock on the Books of the within named Corporation, with full power of Substitution in the premises. Dated _____ 19

In Presence of

_____ _____

NOTICE: THE SIGNATURE TO THIS ASSIGNMENT MUST CORRESPOND WITH THE NAME AS WRITTEN UPON THE FACE OF THIS CERTIFICATE, IN EVERY PARTICULAR WITHOUT ALTERATION OR ENLARGEMENT OR ANY CHANGE WHATSOEVER.

INCORPORATED UNDER
THE LAWS OF

NUMBER
215

PALM SPRINGS HOLI

CAPITAL STOCK

3,000 SHARES PREFERRED STOCK
$100 PAR VALUE

*THIS CERTIFIES that*_____ *Shares of the*

transferable only on the books of the Corporation by the holder thereof in

The preferences, privileges, and restrictions granted to or imposed upon the respective

The holders of record of the preferred shares shall be entitled to receive for any cal
or net profits earned during such calendar year, dividends at the rate of six per cent (6%)
as the board of directors from time to time may determine. The right to such dividends on pre
by reason of the fact that dividends on such shares are not declared in prior years. In
such calendar year on account of fixed charges, taxes, insurance, repairs, renewals, re
all debts and/or liabilities of the corporation, and after the declaration of dividends in
calendar year remain. It shall be the duty of the directors to declare and pay
amount of such net profits, but in no event in an amount in excess of an amount
yearly or quarterly as the directors may determine. No dividends shall be paid
calendar year, unless all dividends *theretofore* declared upon preferred shares
tion, the holders of the preferred shares shall be entitled to be paid out of the assets of the cor
shares, an amount equal to the par value of said preferred shares, whether such liquidation or
the aggregate amount of all unpaid dividends declared thereon. Upon such notice to the record
election, expressed by resolution of the board of directors, may redeem all or any of the pre
resolution of the directors and in such notice, at a price (herein called the "redemption price")
equal to the aggregate amount of all unpaid dividends declared thereon, all by such method as
From and after the date fixed in any such notice as the date of redemption, unless default be
of the redemption price pursuant to such notice, all dividends on the preferred shares thereby
of the corporation, except the right to receive the redemption price, shall cease and determine,
transfer of such shares, shall be deemed to consent to the purchase or redemption or retirement

Except as to the matters and things as stated, no distinction shall exist between said

IN WITNESS WHEREOF, the duly authorized officers of this Corp

For value Received hereby sell, assign and transfer unto

Shares of the Capital Stock represented by the within Certificate and do hereby irrevocably constitute and appoint Attorney to transfer the said Stock on the Books of the within named Corporation, with full power of substitution in the premises. Dated 19

In Presence of

NOTICE. THE SIGNATURE TO THIS ASSIGNMENT MUST CORRESPOND WITH THE NAME AS WRITTEN UPON THE FACE OF THIS CERTIFICATE IN EVERY PARTICULAR WITHOUT ALTERATION OR ENLARGEMENT OR ANY CHANGE WHATEVER

Bondholders' Protective Committee

PALM SPRINGS HOTEL COMPANY

First Mortgage 7% Sinking Fund Gold Bonds

1037 SOUTH BROADWAY

LOS ANGELES, CALIFORNIA

March 3, 1932.

TO THE HOLDERS OF FIRST MORTGAGE BONDS PALM SPRINGS HOTEL COMPANY:

The undersigned committee, under the provisions of that certain Deposit Agreement, dated August 20, 1931, covering the First Mortgage Seven Per Cent. Sinking Fund Gold Bonds of Palm Springs Hotel Company, has, for the past several months, been engaged in making a survey of the condition of the company and of this property; and in working out a plan for the best interests of the bondholders.

The El Mirador Hotel property at Palm Springs, California, is owned by the Palm Springs Hotel Company and is operated by the El Mirador Hotel Operating Company, Ltd., under a lease executed in May, 1927. The total amount heretofore invested in the project is in excess of $900,000.00. Of this sum, $309,000.00 is represented by bonds now issued and outstanding; in addition there are certain obligations on account of a sprinkler contract, lease contracts, taxes and other charges totaling about $60,000.00, as hereinafter more definitely described, which must now be taken care of. The balance of the invested capital is represented by second mortgages, unsecured debts, and the amount originally paid in by stockholders, plus stockholders' advances and assessments.

Your committee is of the opinion that the stockholders of the two hotel companies have done everything within their power to carry on and that they can do no more. They have, during the past three years, put large sums of money into the undertaking; all of which, together with their original investment, is apparently lost.

The hotel was constructed in the summer and fall of 1927, at which time construction costs, as well as the cost of furnishings, were greatly in excess of those of today. In addition, actual depreciation over the five years has been very large. The cost of new furnishings, of the type now in the hotel, is about one-half of the original purchase price; and depreciation thereon is always heavy, particularly in a desert climate.

Owing to the fact that there were not a sufficient number of bonds deposited with the committee prior to November 1, 1931, in order to enable the committee to take any concerted action before it was necessary to open the hotel for this winter season, your committee, in cooperation with the hotel companies and with R. D. Lacoe, Sr., worked out a plan for operations this year. It was determined by all interested parties that the hotel must be kept open this season and operated as a going concern. This was very important, particularly to the bondholders. If the hotel had remained closed, not only would a valuable good-will have been lost, thus causing an unwarranted depreciation in the value of the whole project, but there would also have been considerable expense in caring for the vacant buildings and grounds.

At present there are deposited with your committee, bonds of a face value of $172,000.00. In

that must be taken care of in order to preserve the asset value of the property. Of such obligations, there are (a) the sprinkler system contract, which was originally $40,000.00, and upon which approximately $13,500.00 remains unpaid; (b) certain lease or purchase contracts, having an unpaid balance of only $11,500.00 and covering furnishings with a value much in excess of the balance due; (c) accrued and unpaid taxes as of April 1, 1932, exceeding $15,000.00; (d) the expenses during the summer months of watchman, caretakers and gardeners, in addition to normal expenses for water, electricity, taxes and insurance; (e) large fees, costs and expenses in the event of foreclosure and/or purchase, and in any event the expenses and costs of reorganization and/or acquisition; (f) about $10,000.00 for working capital to begin operations for the coming season.

In addition to the foregoing, your committee is convinced that it will be necessary to expend a large sum to place the property, furnishings and equipment in a satisfactory operating condition. In order that we might have all of the facts, Mr. Clyde Mowder, the supervising engineer of the Los Angeles Investment Company, made a visit to the property for the purpose of ascertaining requirements. After consulting with Mr. Mowder, with the present operators of the hotel and with others, we have come to the conclusion that it is not only advisable but really a necessity that approximately $90,000.00 be expended in making vital repairs, changes and improvements. Therefore, the total of the obligations of the company which, either technically or in practical effect, are prior to or on a par with the bonds, and the cost of the repairs and improvements which are deemed absolutely essential, is $150,000.00.

PLAN OF REORGANIZATION

Subject to the approval of the State Corporation Department, we propose that a corporation be organized, with an authorized Six Per Cent. Non-Assessable, Non-Cumulative, Preferred Stock of $300,000.00, of the par value of $100.00 per share, callable at par and an authorized Common Stock of 7500 shares, of no par value. This corporation would acquire the bonds of those depositing bondholders who approve this plan, and of R. D. Lacoe, Sr., and his associates, and such of the few non-deposited bonds as it could secure. Upon such acquisition, the corporation would institute the necessary proceedings and/or take the necessary steps for the acquisition and/or sale, by foreclosure or otherwise, of all of the bonds, hotel property, furnishings and good-will, free of any claims whatsoever except those charges in the estimated amount of $60,000.00, which must be provided for as hereinabove indicated. Mr. R. F. Ingold or other representative of the assenting bondholders will be on the board of directors of the new corporation.

In order to take care of these obligations, and also to raise the necessary funds for changes, repairs and improvements, it is proposed that this new corporation create an issue, as a prior lien against the property, of $150,000.00 in First Mortgage Seven Per Cent. Bonds.

There will be issued to each present owner of a $1000.00 bond, ten shares of Six Per Cent. Non-Cumulative Preferred Stock, and one $500.00 Seven Per Cent. Bond of the new issue, for each $1000.00 bond of the old issue, and the payment by such bondholder into the corporation's treasury of $500.00 in cash. In the event any present bondholder does not desire to purchase additional bonds, then such bondholder, for each $1000.00 bond, shall be entitled to receive six shares of said Preferred Stock and four shares of Common Stock (holders of $500.00 bonds shall be entitled to one-half of the foregoing).

Any bonds not sold to present bondholders under the foregoing plan, may be sold to the public at such price and under such terms and with such bonus of Preferred Stock as your committee and/or the directors of the new corporation may deem necessary or best; provided, however, that if there are not sufficient subscribers to the proposed new bond issue to effect this plan of reorganization, or if for any other reason the

insurance; (e) large fees, costs and expenses in the event of foreclosure and/or purchase, and in any event the expenses and costs of reorganization and/or acquisition; (f) about $10,000.00 for working capital to begin operations for the coming season.

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Any bonds not sold to present bondholders under the foregoing plan, may be sold to the public at such price and under such terms and with such bonus of Preferred Stock as your committee and/or the directors of the new corporation may deem necessary or best; provided, however, that if there are not sufficient subscribers to the proposed new bond issue to effect this plan of reorganization, or if for any other reason the Board of Directors of the new corporation deems it inadvisable to issue said bonds; then and in that event said offer to present bondholders of a participation in the new issue shall be void and of no effect; and said present bondholders shall be entitled to receive only their six shares of Preferred Stock and four shares of Common Stock, as hereinabove provided; likewise the Board of Directors of the corporation is hereby authorized to offer and/or give said bonus of four shares of Preferred Stock or any part thereof per each unit of $1000.00 advanced, to the person lending or advancing said monies and/or the person instrumental in obtaining the same, and such loan may be secured in like manner as the proposed bond issue or otherwise.

Any shares of the authorized Common Stock, remaining unissued under the foregoing, will be issued to R. D. Lacoe, Sr., and/or his order. In consideration whereof, he agrees not only not to oppose the plan herein outlined, but to assist in its fulfillment. He agrees to undertake the voting control and management of the new corporation, and in the event it acquires the property as herein indicated, to cause to be placed in the treasury of the corporation, prior to November 1, 1932, sufficient monies from said sale of bonds and/or Preferred Stock and/or otherwise to meet the requirements indicated in "a" to "f," inclusive, above. Your committee realizes fully that it is not properly equipped to undertake the operation of a resort hotel project at Palm Springs. It realizes, likewise, that it would be extremely difficult, at this time and under existing conditions, to raise money for any hotel project, particularly for a resort hotel with a poor earning record over the past four years, and that it is only fair and proper to give the large bonus of Common Stock to any responsible party whom it feels is capable of carrying on successfully.

Your committee has spent a great deal of time in connection with this matter and is of the unanimous opinion that, under existing conditions, the plan above outlined is for the best interests of the bondholders and affords the best available opportunity for the bondholders to eventually get back all or a substantial proportion of their original investment, and none of the assenting bondholders represented by your committee will be required to furnish additional money at this difficult period to protect the project or to pay any of the costs, expenses, or advances to your committee as the same will be assumed by the new corporation when the plan is consummated.

If this plan is not consummated, seemingly the only other alternative is to proceed with the foreclosure of the Trust Indenture. Inasmuch as your committee has had deposited with it only $172,000.00 face value of bonds, it can readily be seen that, with obligations of about $60,000.00 necessary to be taken care of, it would require a considerable amount of cash to make any substantial bid for the property at the sale and to protect it thereafter. This would entail an immediate large assessment against the depositing bondholders. Furthermore, such procedure might easily result in expensive litigation and such long delays that the hotel could not be open for business next fall.

Your committee is convinced that only with the cooperation of substantially all bondholders will the project be placed in a condition for operations next fall. Furthermore, by agreeing to the foregoing plan, and with the assurance of Mr. R. D. Lacoe, Sr., and his associates that sufficient money will be raised to satisfy the holders of prior obligations, the expenses of foreclosure and or of reorganization, and monies required to open the hotel and operate it next season, the bondholders are assured of the continuance of the project as a going concern.

While under the terms of the deposit agreement, your committee was delegated with authority to enter into any plan of which it approved, nevertheless, in order that no one may be compelled to join in the plan unless satisfied that it is the best plan that can be worked out under existing conditions, your committee will allow any bondholder, who is not satisfied, to withdraw at this time his or her bonds.

Every holder of the old bonds, now on deposit under said deposit agreement, may withdraw his bonds by paying, on or before March 20, 1932, to the said depositary or to the Bondholders' Protective Committee his or her pro rata share of the committee's expenses, advances and obligations, and by presenting his deposit receipts to said depositary and withdrawing deposited bonds at the time of such payment.

It is agreed that the committee may change the above indicated plan in any manner which is finally approved by the board of directors of the corporation and the State Corporation Department, and shall have full power

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the large bonus of Common Stock to any responsible p
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revocably authorized and instructed by all non-
actical operation the above indicated plan in its
ry or advisable; and the committee is hereby
sary or proper to enable it to carry out said plan
nces which it may deem necessary or best. The

committee is hereby vested with legal title to all deposi
Protective Agreement heretofore executed, except as he
adopted.

It is, of course, understood that the plan herein ou
sufficient number of bondholders represented by your
of the details of the plan have not yet been agreed upo
approval of the State Corporation Department.

Your committee heartily recommends and urges th
hereinabove outlined. **There is enclosed herewith for y**
request that you execute and return immediately in or
in effect at the earliest possible moment. Inasmuch as th
legal details taken care of, it is necessary that all possi
the plan.

The foregoing plan of reorganization is hereby a
tion thereof is indicated by the signatures of all of the

ted bonds and all provisions of the Bondholders' rein finally modified, are hereby confirmed and

tlined can only be consummated in the event a committee consent hereto, and further, that all n and that the plan as a whole is subject to the

at each of the bondholders consent to the plan your signature, a consent which we respectfully der that the plan of reorganization may be put e corporation has to be formed, and many other ble time be saved to assure the carrying out of

dopted by said committee, and its recommenda- nembers thereof.

A. R. LE ROY,
E. A. GRUMM,
R. F. INGOLD,
Bondholders' Protective Committee.

[Endorsed]: No. 9661. United States Circuit Court of Appeals for the Ninth Circuit. Commissioner of Internal Revenue, Petitioner, vs. Palm Springs Holding Corporation, Respondent, and Palm Springs Holding Corporation, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of the United States Board of Tax Appeals.

Filed October 12, 1940.

PAUL P. O'BRIEN,
Clerk of the United States Circuit Court of Appeals
for the Ninth Circuit.

No. 9661

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

PALM SPRINGS HOLDING CORPORATION,
Respondent,

and

PALM SPRINGS HOLDING CORPORATION,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Upon Petitions to Review a Decision of the United States Board of Tax Appeals

PROCEEDINGS HAD IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

PARKER PRINTING COMPANY, 545 SANSOME STREET, SAN FRANCISCO

United States Circuit Court of Appeals for the Ninth Circuit

Excerpt from Proceedings of Monday, March 31, 1941.

Before: Mathews and Stephens, Circuit Judges and Hollzer, District Judge.

[Title of Cause.]

ORDER OF SUBMISSION

Ordered petitions to review herein argued by Mr. L. W. Post, Special Assistant to the Attorney General, counsel for the Commissioner, and by Mr. Frank Mergenthaler, counsel for taxpayer, and submitted to the Court for consideration and decision.

United States Circuit Court of Appeals for the Ninth Circuit

Excerpt from Proceedings of Wednesday, May 14, 1941.

Before: Denman, Mathews and Healy, Circuit Judges.

[Title of Cause.]

ORDER DIRECTING FILING OF OPINION AND FILING AND RECORDING OF JUDGMENT.

By direction of the Court, Ordered that the typewritten opinion this day rendered by this court in

above cause be forthwith filed by the clerk, and that a judgment be filed and recorded in the minutes of this court in accordance with the opinion rendered.

[Title of Circuit Court of Appeals and Cause.]

PETITIONS TO REVIEW A DECISION OF THE UNITED STATES BOARD OF TAX APPEALS.

Before Mathews and Stephens, Circuit Judges, and Hollzer, District Judge:

Mathews, Circuit Judge:

These are petitions to review a decision of the Board of Tax Appeals redetermining claimed deficiencies in respect of income and excess profits taxes of Palm Springs Holding Corporation (hereafter called the taxpayer) for the taxable year ended May 31, 1936.

In May, 1932, the taxpayer acquired bonds of Palm Springs Hotel Company, a corporation (hereafter called the Hotel Company), of the face value of $292,000. The bonds were secured (1) by a mortgage on real property owned by the Hotel Company and leased by it to Palm Springs Hotel Operating Company,[1] a corporation (hereafter called the Operating Company), and (2) by a pledge of the lease and a chattel mortgage securing performance of the Operating Company's obligations

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1. Later known as El Mirador Hotel Operating Company.

thereunder, the chattel mortgage being on furniture and fixtures owned by the Operating Company. Both the realty mortgage and the pledge were to California Trust Company, as trustee.

On July 15, 1932, the bonds being in default, the mortgaged realty and the pledged lease and chattel mortgage were sold by the trustee and purchased by the taxpayer for a bid price of $61,800, of which $18,767.96 was paid in cash, the balance ($43,032.04) by the taxpayer's surrendering its Hotel Company bonds to the trustee. Thereafter the taxpayer foreclosed the chattel mortgage and, at the foreclosure sale, August 2, 1932, purchased the mortgaged furniture and fixtures for a bid price of $20,179.25.

All the property mentioned—the real property purchased on July 15, 1932, and the personal property (furniture and fixtures) purchased on August 2, 1932—was used by the taxpayer in its trade or business in the taxable year ended May 31, 1936. Hence the taxpayer, in computing its net income for the taxable year, was entitled to an allowance for depreciation of the property. Revenue Act of 1934,[2] § 23 (1).

This the Commissioner of Internal Revenue conceded, but he and the taxpayer did not agree as to the basis on which such depreciation should be determined. The taxpayer contended that the basis of the real property was the same as it would have been in the hands of the Hotel Company, with ad-

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2. Act of May 10, 1934, c. 277, 48 Stat. 680-772.

justments as provided in § 113(b) of the Revenue Act of 1934, and that the basis of the personal property was the same as it would have been in the hands of the Operating Company, with similar adjustments. The Commissioner contended that the basis of all the property was the cost thereof to the taxpayer, with adjustments as provided in § 113(b). With respect to the real property, the Board agreed with the taxpayer. With respect to the personal property, it agreed with the Commissioner. Both parties have petitioned for review.

Section 114(a) of the Revenue Act of 1934 provides that, with inapplicable exceptions, the basis on which depreciation is to be allowed in respect of any property shall be "the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property." Section 113(b) provides that the adjusted basis for determining such gain shall be the basis determined under § 113(a), with specified adjustments. Section 113(a) provides that, with specified exceptions, "the basis of property shall be the cost of such property." Of the fourteen exceptions specified in § 113(a), the only one which could possibly be regarded as applicable here is the one specified in § 113(a)(12), which provides:

"If the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis thereof, for the purposes of the Revenue Act of 1932,[3] was prescribed

3. Act of June 6, 1932, c. 209, 47 Stat. 169-289.

by section 113(a)(6), (7), or (9) of such Act, then for the purposes of this act the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932."

The property here involved was acquired after February 28, 1913, in a taxable year beginning prior to January 1, 1934. The taxpayer, however, does not contend that the basis of the property was that described in § 113(a)(6) or § 113(a)(9) of the Revenue Act of 1932. Its contention is that the basis of the property was that prescribed in § 113 (a)(7) of the Revenue Act of 1934,[4] which is identical with § 113(a)(7) of the Revenue Act of 1932, which provides:

"If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made . . . "

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4. In support of its contention that the basis of the property was that prescribed in § 113(a)(7), the taxpayer cites both § 113(a)(6) and § 113(a)(7) of the Revenue Act of 1934, being apparently under the delusion that both prescribe the same basis. Actually, they prescribe different bases. Thus, if applicable, § 113(a)(6), instead of supporting the taxpayer's contention, would require its rejection.

That the property here involved was acquired after December 31, 1917, by a corporation (the taxpayer) is conceded. Questions to be decided are (1) whether the property was acquired in connection with a reorganization and (2) whether immediately after the transfer an interest or control in the property of 50 per centum or more remained in the same persons or any of them.

Section 112(i) of the Revenue Act of 1932 defines the term "reorganization" as "(A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected."[5]

The taxpayer does not contend that any of the property here involved was acquired in connection with any transaction mentioned in subdivision (B), (C) or (D) of § 112(i). Its contention is that the property was acquired in connection with a merger

5. With later definitions—found in § 112(g) of the Revenue Acts of 1934, 1936 and 1938 and § 112(g) of the Internal Revenue Code—we are not here concerned.

or consolidation mentioned in subdivision (A), namely, the acquisition by one corporation (the taxpayer) of substantially all the properties of two other corporations (the Hotel Company and the Operating Company). Thus, it is contended, the property was acquired in connection with a reorganization within the meaning of § 112 (i).

The real property and other property acquired by the taxpayer at the trustee's sale on July 15, 1932, constituted all the property of the Hotel Company. The personal property acquired by the taxpayer at the foreclosure sale on August 2, 1932, constituted all the property of the Operating Company. It does not, however, necessarily follow that these acquisitions or either of them constituted a merger or consolidation—and hence a reorganization—within the meaning of § 112 (i).

It should here be recalled that the taxpayer paid for the real property partly in money, partly in bonds of the Hotel Company, and paid for the personal property in money. Neither the Hotel Company nor the Operating Company got anything for its property except the satisfaction or partial satisfaction of certain indebtedness. Neither received any stock or bonds of the taxpayer. Neither retained any stake or proprietary interest in the corporate enterprise in which theretofore it had engaged. Hence, the transactions whereby the taxpayer acquired the property were mere sales or exchanges. Neither amounted to a reorganization. Pinellas Ice & Cold Storage Co. v. Commissioner,

287 U. S. 462, 468-470; LeTulle v. Scofield, 308 U. S. 415, 419-421; Helvering v. Tyng, 308 U. S. 527; Commissioner v. Bondholders Committee, 9 Cir., ... F. 2d ....., decided March 8, 1941.

The contrary view derives no support from Commissioner v. Kitselman, 7 Cir., 89 F. 2d 458, or from Newberry Lumber & Chemical Co. v. Commissioner, 6 Cir., 94 F. 2d 447. For the Kitselman and Newberry cases, so far as relevant here, were in effect overruled by LeTulle v. Scofield and Helvering v. Tyng, supra. In Commissioner v. Southwest Consolidated Corp., 5 Cir., ... F. 2d....., cited by the taxpayer, stock of the transferee was exchanged for stock, as well as bonds, of the transferor, thus permitting the transferor's stockholders to retain a proprietary interest in the corporate enterprise. In the case at bar, the transferors' stockholders got nothing.

We reject also the taxpayer's contention that immediately after the above mentioned transfers an interest or control in the transferred property of 50 per centum or more remained in the same person as before, namely, the taxpayer. For prior to the transfers the taxpayer had no interest or control in any of the property, but was merely a creditor of the owners—the Hotel Company and the Operating Company. And this is true despite the fact that the Hotel Company's debt was evidenced by bonds.

We regard as immaterial the fact, much stressed by the taxpayer, that at the time of the transfers each company had only one stockholder and only

ten shares of stock outstanding. For whether a corporation has one or many stockholders, or ten or ten thousand shares outstanding, the rule is that its stockholders, not its creditors, control and, in effect, own the corporation. The rule is applicable here.

With respect to the personal property involved, the Board held, and properly so, that the basis was not that prescribed in § 113(a)(7), but was the cost of such property to the taxpayer, with adjustments as provided in § 113(b) of the Revenue Act of 1934. That should have been its holding with respect to all the property, real and personal.

Decision reversed and case remanded for further proceedings in conformity with this opinion.

[Endorsed]: Opinion. Filed May 14, 1941. Paul P. O'Brien, Clerk.

United States Circuit Court of Appeals
for the Ninth Circuit

No. 9661.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

PALM SPRINGS HOLDING CORPORATION,
Respondent.

PALM SPRINGS HOLDING CORPORATION,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

JUDGMENT

Upon Petitions to Review a Decision of the United States Board of Tax Appeals, This Cause came on to be heard on the Transcript of the Record from the United States Board of Tax Appeals and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Board of Tax Appeals in this Cause be, and hereby is reversed, and that this cause be, and hereby is remanded to the said Board of Tax Appeals for further proceedings in conformity with the opinion of this court.

[Endorsed]: Filed and entered May 14, 1941. Paul P. O'Brien, Clerk.

[Title of Circuit Court of Appeals and Cause.]

CERTIFICATE OF CLERK, U. S. CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT, TO RECORD CERTIFIED UNDER RULE 38 OF THE REVISED RULES OF THE SUPREME COURT OF THE UNITED STATES.

I, Paul P. O'Brien, as Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, do hereby certify the foregoing ninety-six (96) pages, numbered from and including 1 to and including 96, to be a full, true and correct copy of the entire record of the above-entitled case in the said Circuit Court of Appeals, made pursuant to request of counsel for the taxpayer, and certified under Rule 38 of the Revised Rules of the Supreme Court of the United States, as the originals thereof remain on file and appear of record in my office.

Attest my hand and the seal of the said the United States Circuit Court of Appeals for the Ninth Circuit, at the City of San Francisco, in the State of California, this 30th day of July, A. D. 1941.

[Seal] PAUL P. O'BRIEN,
Clerk.

IN THE

Supreme Court of the United States

October Term, 1941

No. 503

PALM SPRINGS HOLDING CORPORATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

THOMAS R. DEMPSEY,
1104 Pacific Mutual Building, Los Angeles,
Attorney for Petitioner.

SUBJECT INDEX.

PAGE

Petition for Writ of Certiorari 1

Summary statement of matter involved 1

Jurisdiction 6

Questions presented 7

Reasons relied on for the allowance of the writ 9

Brief in Support of Petition for Writ of Certiorari 13

Opinions of the court below 13

Jurisdiction 14

Statement of the case 14

Assignments of error 14

Summary of argument 16

Argument 17

The Circuit Court erred in refusing to hold that the steps by which the petitioner acquired all the property of the two old corporations constituted a tax-free reorganization which entitles the petitioner to use the adjusted bases of the old companies in computing its depreciation for income tax purposes 19

The Circuit Court of Appeals for the Ninth Circuit has decided an important question of federal law which has not been, but should be, settled by the Supreme Court of the United States 24

Conclusions 25

TABLE OF AUTHORITIES CITED.

CASES. PAGE

Altshuler, B. T. A. Memo. Docket, No. 84568 (C. C. H. 10432-C) 10

Commissioner v. Alabama Asphaltic Limestone Co., Inc., 119 Fed. (2d) 819 (C. C. A. 5th) 9, 15, 21, 25

Commissioner v. James Q. Newton, 42 B. T. A. 473 ..... 23, 25

Commissioner v. Janes Q. Newton Trust, ... Fed. (2d) ..... (C. C. A. 10th) 9, 21

Commissioner v. Kitselman, 89 Fed. (2d) 458 (C. C. A. 7th) 8, 9, 10, 11, 15, 20, 21, 24

Commissioner v. Newberry L. & C. Co., 94 Fed. (2d) 447 (C. C. A. 6th) 8, 9, 10, 15, 20, 21

Commissioner v. New Haven and Shore Line Railway Co., ... Fed. (2d) ..... (C. C. A. 2d), decided July 21, 1941, reported in Prentice-Hall 1941 Tax Service, Par. 62,841 ..... 9, 21, 22, 25

Commissioner v. Palm Springs Holding Corp., 119 Fed. (2d) 846 21

Commissioner v. Southwest Consolidated Corp., 119 Fed. (2d) 561 (C. C. A. 5th) 9, 15, 21, 25

Commissioner of Internal Revenue v. Marlborough House, Inc., 118 Fed. (2d) 511 21

Helverding v. Tyng, 308 U. S. 527 ..... 8, 15, 21, 23, 25

Howard Hotel Corp., 39 B. T. A. 1147 10

Leckie, In re, 37 B. T. A. 252 10

LeTulle v. Scofield, 308 U. S. 415 ..... 8, 10, 11, 15, 21, 23, 24, 25

Post Office Building Co., B. T. A. Memo. Docket No. 93083 (C. C. H. 10795-B) 10

Southwest Consolidated Corp., B. T. A. Memo. Docket No. 93321 (C. C. H. 10808-I) 10

Sunstein, B. T. A. Memo. Docket, No. 82529 (C. C. H. 9954-E) 10

York Furniture Co., B. T. A. Memo. Docket No. 92778 (C. C. H. 10825-B) 10

MISCELLANEOUS. PAGE

C. C. H. Illustrative Bulletin E, May 8, 1940 24

18 Tax Magazine 492, Income Tax Problems of Reorganization, Virgil S. Chandler, December, 1940, University of Kansas City Law Review, Vol. IX, p. 22 24

STATUTES.

Judicial Code, Sec. 240(a), as amended by Act of February 13, 1925, Chap. 229, Stat. 938 (28 U. S. C. A., Sec. 347(a)) 6, 14

Revenue Act of 1932, Sec. 112(b)(3) 7

Revenue Act of 1932, Sec. 112(b)(4) 7

Revenue Act of 1932, Sec. 112(i) 7

Revenue Act of 1932, Sec. 112(i)(1)(2) and (j) 7, 19

Revenue Act of 1932, Sec. 113(a)(7) 7, 19

Revenue Act of 1934, Sec. 113(a)(12) 7, 19

Revenue Act of 1934, Sec. 114(a) 19

Revised Statutes, Sec. 1008, as amended (28 U. S. C. A., Sec. 350) 6, 14

INDEX TO APPENDIX.

Revenue Act of 1932, 26 U. S. C. A., Sec. 112 3

Revenue Act of 1932, 26 U. S. C. A., Sec. 113 3

Revenue Act of 1932, 26 U. S. C. A., Sec. 114 2

Revenue Act of 1934, 26 U. S. C. A., Sec. 23 1

Revenue Act of 1934, 26 U. S. C. A., Sec. 113 2

Revenue Act of 1934, 26 U. S. C. A., Sec. 114 1

Revenue Act of 1936, 26 U. S. C. A., Sec. 1 1

IN THE

Supreme Court of the United States.

October Term, 1941

No. .....

PALM SPRINGS HOLDING CORPORATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI.

To the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States:

The petition of PALM SPRINGS HOLDING CORPORATION, a corporation, respectfully represents:

Summary Statement of Matter Involved.

The controversy here involved relates to a deficiency in Federal income taxes and excess-profits taxes of the petitioner for the fiscal year ended May 31, 1936, in the sum of $3612.78. [R. 5.]

The Palm Springs Hotel Co., a corporation, was the owner of a hotel. In July, 1932, the corporation had outstanding $309,000.00 of its first mortgage bonds which were a lien upon the hotel property. The hotel was leased

to another company known as the El Mirador Hotel Operating Co., which owned the furniture and fixtures. To secure the performance of the terms of the lease, the El Mirador Hotel Operating Co. gave a chattel mortgage upon the said furniture and fixtures to the said Palm Springs Hotel Co. This latter company in turn pledged the lease and chattel mortgage as part of the security for its said bond issue. [R. 23.]

In the Spring of 1931 both the Palm Springs Hotel Co. and the El Mirador Hotel Operating Co. were in financial difficulties and were unable to meet their respective obligations, having sustained large operating deficits. [R. 24.] Under date of August 20, 1931, a bondholders protective committee for Palm Springs Hotel Co. first mortgage seven per cent s. f. gold bonds was formed to protect the interests of the holders of said bonds. [R. 25.] A copy of the bondholders' deposit agreement is set forth at pages 70 to 73 of the record.

The petitioner was formed under the laws of the State of California on April 1, 1932 [R. 22 and 25], pursuant to a plan of reorganization for the purpose of acquiring said bonds and ultimately all of the properties of said Palm Springs Hotel Co. and of the El Mirador Hotel Operating Co. During the month of May, 1932, the petitioner issued all of its preferred shares and part of its common shares in exchange for $292,000.00 par value of said bonds. [R. 26.] The remainder of its common shares were issued to R. D. Lacoe in consideration for his agreement to pay up to $1,000.00 the costs of incorporating the petitioner and for his agreement to lend moneys to the petitioner. Lacoe was also a holder of a large block of the bonds for which the other shares were issued. [R. 26 and 27.]

On or about July 15, 1932, petitioner was the successful bidder at a Trustee's sale of all of the properties of Palm Springs Hotel Co. held pursuant to the terms of the indenture securing said bonds. The bid price was $61,800.00, which was paid as follows:

(a) Payment of cash amounting to $18,767.96

(b) By the delivery to the Trustee of bonds of Palm Springs Hotel Co. having a face value of $292,000.00 for the balance of 43,032.04

$61,800.00

The said properties were acquired subject to obligations prior to the lien of the bonds amounting to $38,949.76, of which amount $13,500.00 constituted a lien against furniture and fixtures. [R. 27 and 28.]

Among the assets acquired by the petitioner at the Trustee's sale were the said lease, the indebtedness thereon and the said chattel mortgage. [R. 27 and 28.]

On August 2, 1932, the taxpayer foreclosed on the chattel mortgage on the furniture and fixtures. [R. 28.] At the foreclosure sale the furniture and fixtures were sold to the taxpayer pursuant to a decree of foreclosure for a bid price of $20,179.25. [R. 28.] The amount of the judgment for the indebtedness of the El Mirador Hotel Operating Co. under the lease and chattel mortgage was $77,918.79. [R. 28.] The furniture and fixtures constituted all of the properties of the El Mirador Hotel Operating Co. [R 27.]

The properties formerly owned by Palm Springs Hotel Co. and acquired by petitioner as aforesaid constituted

what is known as the El Mirador Hotel at Palm Springs, California. [R. 23.]

All of the capital stock of Palm Springs Hotel Co. and El Mirador Hotel Operating Co., excepting in each case ten (10) shares of capital stock owned by Warren B. Pinney, who was president of both companies, had been forfeited for nonpayment of assessments levied against the shares, so that at the time petitioner was organized said Pinney was the sole stockholder of both corporations. [R. 24 and 25.] Said Pinney received no capital stock of petitioner for his holdings of capital stock of either of the two predecessor corporations, nor did any other stockholders of such corporations receive any shares of petitioner for any rights which they may have had as such stockholders. [R. 29 and 30.] Said Pinney received 1,000 shares of common stock of petitioner from R. D. Lacoe for his services in the reorganization and as an inducement to continue as manager of the hotel. [R. 29.]

The petitioner on its Federal income tax return for the year under review deducted depreciation upon the hotel buildings and the furniture and fixtures upon the bases of the two predecessor corporations. [R. 15.]

The cost to Palm Springs Hotel Co., including all additions up to July 15, 1932, of the buildings which were acquired by petitioner as aforesaid was $686,731.97. Subsequently the petitioner, up to May 31, 1936, expended $82,652.81 for additions to said buildings. The useful life of the buildings was twenty years from January 1, 1928. [R. 29.]

The cost to El Mirador Hotel Operating Co. including all additions up to August 2, 1932, of the furniture and fixtures acquired by petitioner on the date named was $232,544.10. Subsequently petitioner acquired additional furniture and fixtures up to May 31, 1936, at a cost of $40,485.18. The useful life of said furniture and fixtures was twelve years from the date of acquisition new. [R. 29.]

Upon the examination of the return, the Commissioner of Internal Revenue disallowed the depreciation upon the basis mentioned and based his determination of deductible depreciation upon the said furniture and fixtures for income tax purposes upon what he claimed to be the fair market value thereof as of the date of foreclosure of the chattel mortgage. [R. 15.]

The amount of depreciation on the said items allowed by the Commissioner was $15,892.97 [R. 15], based on a revised cost of the furniture and fixtures to May 31, 1935, of $126,774.21, plus additions during the taxable year of $11,334.46, or a total cost of $138,108.67. These figures were based upon the valuation of the items at the date of foreclosure plus subsequent additions. [R. 15.]

From the Commissioner's determination the petitioner appealed to the United States Board of Tax Appeals. The Board decided the issue of depreciation with respect to furniture and fixtures in favor of the Commissioner holding that the taxpayer must use as the basis for depreciation of such items the fair market value thereof

as of the date of foreclosure, plus cost of additions. [R. 4 to 20.]

The United States Board of Tax Appeals determined the issue with respect to the building in favor of the petitioner herein, holding that the petitioner was entitled to use its predecessor's adjusted base for tax purposes. [R. 30, 31 and 32.]

Both the Commissioner and the petitioner sought reviews by the United States Circuit Court of Appeals for the Ninth Circuit of the portion of the decision of the Board of Tax Appeals which was adverse to them respectively. [R. 36, 46.] The Circuit Court ordered the proceedings under the two petitions consolidated. [R. 67, 68.]

The United States Circuit Court of Appeals for the Ninth Circuit reversed the Board's decision and remanded the case for further proceedings. The Circuit Court held in effect that there was no tax free reorganization and the petitioner was not entitled to use its predecessor corporations' bases for the purpose of computing deductible depreciation of buildings, furniture and fixtures.

Jurisdiction.

1. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925, Chapt. 229, Stat. 938, 28 U. S. C. A. Section 347 (a); Rev. Stat. Section 1008 as amended (28 U. S. C. A. Section 350).

2. The date of the entry of the judgment of the Circuit Court of Appeals of the Ninth Circuit herein sought to be reviewed is May 14, 1941. [R. 96.]

Questions Presented.

1. Did not the Circuit Court of Appeals of the Ninth Circuit err in holding that the petitioner (Palm Springs Holding Corporation) did not acquire the hotel buildings in connection with a reorganization as that term is defined in Section 112 (i) of the Revenue Act of 1932, so that the basis for depreciation of the property in its hands is the same basis as that of the Palm Springs Hotel Co., prior owner, pursuant to Section 113 (a) (12) of the Revenue Act of 1934; Sections 112 (b) (3) and (4) and 113 (a) (7) of the Revenue Act of 1932; and Section 112 (i) (1) (2) and (j) of the Revenue Act of 1932?

2. Did not the Circuit Court of Appeals of the Ninth Circuit err in holding that the petitioner (Palm Springs Holding Corporation) did not acquire the hotel furniture and equipment in connection with a reorganization as that term is defined in Section 112 (i) of the Revenue Act of 1932, to which the El Mirador Hotel Operating Company was a party, so that the basis for depreciation of the property in its hands is the same basis as that of the El Mirador Hotel Operating Company, a prior owner, pursuant to Section 113 (a) (12) of the Revenue Act of 1934; Section 112 (b) (3) and (4) of the Revenue Act of 1932; and Sections 112 (i) (1) (2) and (j) and 113 (a) (7) of the Revenue Act of 1932?

3. Did not the Circuit Court of Appeals of the Ninth Circuit err in holding that this case was not controlled by the cases of *Commissioner v. Newberry L. & C. Co.*, 94

Fed. (2d) 447 (C. C. A. 6th), and *Commissioner v. Kitselman*, 89 Fed. (2d) 458 (C. C. A. 7th)?

4. Did not the Circuit Court of Appeals of the Ninth Circuit err in holding that the case of *LeTulle v. Scofield*, 308 U. S. 415, and *Helvering v. Tyng*, 308 U. S. 527, overruled the cases of *Commissioner v. Kitselman, supra*, and *Commissioner v. Newberry L. & C. Co., supra*?

5. Did not the Circuit Court of Appeals of the Ninth Circuit err in holding in the present case the stockholders of the transferor corporations got nothing?

6. Did not the Circuit Court of Appeals of the Ninth Circuit err in holding that the basis for depreciation of said real and personal property was the cost of such property to the petitioner?

7. Were the furniture and fixtures of the El Mirador Hotel Operating Co. and the building of the Palm Springs Hotel Co. acquired by the petitioner in 1932 in connection with a reorganization such as would entitle the petitioner to use the same basis for depreciation of the said real and personal property so acquired as was available to the said El Mirador Hotel Operating Co. and the Palm Springs Hotel Co.?

Reasons Relied on for the Allowance of the Writ.

1. The decision of the Circuit Court of Appeals for the Ninth Circuit is in conflict with the following decisions on the same question in other Circuits:

Commissioner v. Newberry L. & C. Co., 94 Fed. (2d) 447 (C. C. A. 6th);

Commissioner v. Kitselman, 89 Fed. (2d) 458 (C. C. A. 7th). Certiorari denied 302 U. S. 709;

Commissioner v. Southwest Consolidated Corporation, 119 Fed. (2d) 561 (C. C. A. 5th), decided April 19, 1941;

Commissioner v. Alabama Asphaltic Limestone Company, Inc., 119 Fed. (2d) 819 (C. C. A. 5th), decided May 5, 1941;

Commissioner v. New Haven and Shore Line Railway Company, ... Fed. (2d) ..... (C. C. A. 2nd), decided July 21st, 1941, reported in Prentice-Hall 1941 Tax Service, Par. 62,841; and

Commissioner v. James Q. Newton Trust, ... Fed. (2d) ..... (C. C. A. 10th), decided July ....., 1941.

2. The decision of the Circuit Court of Appeals for the Ninth Circuit in this case departs from a long line of authorities, beginning with the case of *Commissioner v. Kitselman, supra*, and including the following decisions of the United States Board of Tax Appeals upon the right of a taxpayer to use a predecessor corporation's basis for

assets through the medium of a foreclosure of a bond issue.

In re Leckie, 37 B. T. A. 252;

Howard Hotel Corp., 39 B. T. A. 1147;

Sunstein, B. T. A. Memo Docket, No. 82529 (C. C. H. 9954-E, February 1938);

Altshuler, B. T. A. Memo Docket, No. 84568 (C. C. H. 10432-C, August 27, 1938);

Post Office Building Co., B. T. A. Memo Docket No. 93085 (C. C. H. 10795-B, July 28, 1939);

Southwest Consolidated Corp., B. T. A. Memo Docket No. 93321 (C. C. H. 10808-I, August 25, 1939);

York Furniture Company, B. T. A. Memo Docket No. 92778 (C. C. H. 10825-B, September 18, 1939).

3. The petitioner is of the belief that the Circuit Court of Appeals for the Ninth Circuit is in error in holding that the case of *LeTulle v. Scofield*, 308 U. S. 415 overruled the *Kitselman* and *Newberry* cases, *supra*.

4. The principle that a reorganization resulting from the foreclosure of a corporate bond issue entitles the successor corporation to use the basis of the predecessor corporation for purposes of computing depreciation is of widespread application and affects a large number of taxpayers, and since the decision in the present case is wholly at variance with the decisions of several other Circuits and with the long line of decisions of the United

States Board of Tax Appeals, it seems fitting that the conflict should be settled. The petitioner is further of the opinion that the facts of the *LeTulle* case, *supra,* are not at all comparable to the facts in the *Kitselman* and *Newberry* cases, *supra,* or the facts in the case at Bar.

5. There is now pending and undetermined before your Honorable Court the petition for writ of certiorari in the cases of *Bondholders Committee, Marlborough Investment Company, First Mortgage Bonds v. Commissioner of Internal Revenue,* and *Marlborough House, Inc., a corporation v. Commissioner of Internal Revenue,* in which cases the United States Circuit Court of Appeals for the Ninth Circuit on March 8, 1941, decided the question similar to the one involved in the present case against the taxpayer.

Wherefore, your petitioner respectfully prays that a writ of certiorari be issued out of and under the seal of your Honorable Court directed to the United States Circuit Court of Appeals for the Ninth Circuit commanding that Court to certify and send to your Honorable Court, on a day certain to be therein named, a full and complete transcript of the record of all proceedings in the case of *Commissioner of Internal Revenue,* Petitioner v. *Palm Springs Holding Corporation,* Respondent, and *Palm Springs Holding Corporation,* Petitioner, v. *Commissioner of Internal Revenue,* Respondent, bearing Docket No. 9661, to the end that the judgment of the United States Circuit Court of Appeals for the Ninth Circuit may be

reviewed and reversed by your Honorable Court, and for such other and further relief as may seem meet and proper.

And your petitioner will ever pray, etc.

PALM SPRINGS HOLDING CORPORATION,
By THOMAS R. DEMPSEY,
Attorney for Petitioner.

The undersigned counsel of record hereby certifies that the foregoing petition is well founded and is not interposed for the purpose of delay.

THOMAS R. DEMPSEY,
Attorney for Petitioner.

IN THE

Supreme Court of the United States

October Term, 1941

No. .....

PALM SPRINGS HOLDING CORPORATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

Opinions of the Court Below.

The decision of the United States Board of Tax Appeals was favorable to the petitioner in respect of the buildings and adverse as to the furniture and fixtures. The opinion of the United States Board of Tax Appeals is a memorandum decision and is unreported; it is dated March 23, 1940. [R. 30.]

The judgment of the Circuit Court of Appeals for the Ninth Circuit in the matter was adverse to the petitioner on both issues. The opinion of the Circuit Court of Appeals for the Ninth Circuit is reported in 119 Fed. (2d) 846. [R. 88.]

Jurisdiction.

1. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by Act of February 13, 1925, 43 Stat. 938, 28 U. S. C. A. Section 347 (a); Rev. Stat. Section 1008 as amended (28 U. S. C. A. Section 350).

2. The date of the judgment of the Circuit Court of Appeals for the Ninth Circuit herein sought to be reviewed is May 14, 1941. [R. 96.]

3. The cases believed by your petitioner to sustain jurisdiction of this Court and relied on for the exercise thereof are referred to in the preceding petition, page 9, to which reference is made to avoid duplication.

Statement of the Case.

The facts have been set forth in the foregoing petition, to which reference is made, to avoid duplication. They show that the petitioner acquired title to all the assets of the two predecessor corporations through a bondholders' foreclosure proceedings and that the petitioner sought to use the predecessors' basis for computing depreciation for income tax purposes.

Assignments of Error.

1. The Circuit Court of Appeals for the Ninth Circuit erred in refusing to hold that the steps taken by the petitioner in acquiring the assets of the Palm Springs Hotel Co. and the El Mirador Hotel Operating Co. constituted a tax free reorganization whereby the petitioner as a party to the reorganization is entitled to the same basis for depreciation as the predecessor insolvent corporations.

2. The Circuit Court of Appeals for the Ninth Circuit erred in refusing to hold that this case is governed by the cases of *Commissioner v. Newberry L. & C. Co.*; 94 Fed. (2d) 447 (C. C. A. 6th); *Commissioner v. Kitselman,* 89 Fed. (2d) 458 (C. C. A. 7th); *Commissioner v. Southwest Consolidated Corporation,* 119 Fed. (2d) 561 (C. C. A. 5th), and *Commissioner v. Alabama Asphaltic Limestone Company, Inc.,* 119 Fed. (2d) 819 (C. C. A. 5th).

3. The Circuit Court of Appeals for the Ninth Circuit erred in holding that the cases of *LeTulle v. Scofield,* 308 U. S. 415, and *Helvering v. Tyng,* 308 U. S. 527 overruled the cases of *Newberry* and *Kitselman, supra.*

4. The Circuit Court of Appeals for the Ninth Circuit erred in rejecting the petitioner's contention that immediately after the above mentioned transfer an interest or control in the transferred property of 50 per centum or more remained in the same persons as before the transfer.

5. The Circuit Court of Appeals for the Ninth Circuit erred in holding that prior to the transfer the taxpayer had no interest or control in any of the property but was merely a creditor of the Hotel Company and the Operating Company.

6. The Circuit Court of Appeals for the Ninth Circuit erred in holding that the basis of the petitioner for the real and personal property was the cost thereof to the petitioner.

Summary of Argument.

The Palm Springs Hotel Co. and the El Mirador Hotel Operating Co. in 1932 were insolvent. The petitioner was the owner of approximately 95% of the outstanding bonds of the Palm Springs Hotel Co. which were a lien upon all of the property of the Palm Springs Hotel Co. By virtue of a foreclosure of the bond issue the petitioner acquired the chattel mortgage, lease and indebtedness of the El Mirador Hotel Operating Co. Owing to the insolvency of these two companies and the superior position of the petitioner as a holder of the bonds and chattel mortgage the petitioner was to all practical effects and purposes a stockholder of the two companies, owning an interest or control in excess of 95% of the assets in both companies because of the disappearance of the equities of the stockholders in the two predecessor corporations. Since the petitioner ultimately acquired all of the assets of the two companies by the issuance of its stock and the petitioner's stockholders were the virtual stockholders of the two predecessor companies, the steps by which it acquired all of the assets of the two old companies constituted a tax free reorganization and consequently petitioner is entitled to use the adjusted basis of the two old companies for the purpose of computing depreciation for income tax purposes.

Argument.

The petitioner held $292,000.00 par value out of $309,000.00 par value of the outstanding first mortgage bonds of the Palm Springs Hotel Co. [R. 23 and 26.] This was approximately 95% of the entire issue. These bonds were secured by an indenture which was a lien upon all of the assets of the obligor. [R. 23.] The Palm Springs Hotel Co. had leased the building to the El Mirador Hotel Operating Co., which latter company was the lessee of the hotel building. [R. 23.] The latter company gave to the Palm Springs Hotel Co. a chattel mortgage on its furniture and fixtures to secure the performance of the terms of the lease. [R. 23.] The Palm Springs Hotel Co. in turn pledged this lease and chattel mortgage as additional security under the indenture securing the bonds. [R. 23.] The Palm Springs Hotel Co. and the El Mirador Hotel Operating Co. were insolvent in 1932 [R. 24], at which time the petitioner was the owner of approximately 95% of the outstanding bonds. All except five shares of the stock of each of the Palm Springs Hotel Co. and the El Mirador Hotel Operating Co. had been sold for assessments and each company bought in all of its respective shares except five shares in each company which were retained by W. B. Pinney, who then became the sole stockholder in each of the two old companies. [R. 24 and 25.] This sole stockholder became a stockholder of the petitioner. [R. 29.]

In 1932 the trustee under the trust indenture sold all of the properties of the Palm Springs Hotel Co. includ-

ing the chattel mortgage and lease to the petitioner who bid $61,800.00 for the said assets. This bid was paid as follows:

Cash	$18,767.96
Bonds of Palm Springs Hotel Co. of the par value of $292,000	43,032.04
	$61,800.00 [R. 27.]

Thereafter the petitioner foreclosed the chattel mortgage given by the El Mirador Hotel Operating Co. in a court proceeding in which the petitioner procured a judgment of $77,918.79 on the said lease. The furniture and fixtures of the El Mirador Hotel Operating Co. were sold to the petitioner under said judgment for $20,179.25. These furniture and fixtures constituted all of the assets of the El Mirador Hotel Operating Co. [R. 28.]

All of said assets were acquired by the petitioner pursuant to a Plan of Reorganization which is set forth in a copy of the Bondholders' Protective Agreement. [R. 70-73 inclusive and 78-81 inclusive.]

The petitioner was entitled to deduct upon its Federal income tax return for its fiscal year ended May 31, 1936, depreciation upon its properties for income tax purposes. This deduction is provided for by Section 23 of the Revenue Act of 1934. [See Appendix for Statutes.] The controversy here arises over the basis to be used for that purpose. The petitioner claims the right to use the adjusted basis of the two old corporations whereas the Commissioner contends that the basis should be the fair market value as of the date of foreclosure. [R. 15.]

The Circuit Court Erred in Refusing to Hold That the Steps by Which the Petitioner Acquired All the Property of the Two Old Corporations Constituted a Tax Free Reorganization Which Entitles the Petitioner to Use the Adjusted Bases of the Old Companies in Computing Its Depreciation for Income Tax Purposes.

Under Section 113 of the Revenue Act of 1934 [see Appendix] the cost of property is the normal basis for computing depreciation. There are exceptions to this rule and it is the contention of the petitioner that the Circuit Court failed to follow a long line of decisions holding that similar transactions resulted in tax free reorganizations which give rise to one of the exceptions mentioned. Reference to Sections 114 (a) and 113 (a) (12) and 113 (b) of the Revenue Act of 1934 will disclose that the provisions of Section 112 (a) and (b), Section 113 (a) (7), and Section 114 (a) of the Revenue Act of 1932 govern the basis upon which the petitioner claims the right to compute depreciation for income tax purposes.

Section 113 (a) (7) of the Revenue Act of 1932, in effect, provides that if property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer of an interest or control of such property of 50% or more remained in the same persons or any of them the basis for depreciation shall be the same as it would be in the hands of the transferor, with certain adjustments.

Section 112 (i) of the same Act defines the term "reorganization" as, among other things. (A) a merger or consolidated (including the acquisition by one corporation of at least a majority of the voting stock and at least a

majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred.

This section defines further the term "a party to a reorganization" as to include both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

Subsection (j) of the same section defines the word "control" as meaning at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

The petitioner's application for a Writ of Certiorari is grounded upon the fact that a number of cases in which the factual situations are very similar to the one at bar have been passed upon in the Circuit Courts of Appeals in at least six Circuits. With the exception of the Ninth Circuit, all of the Circuits in which the cases have arisen have held that a tax free reorganization resulted where bondholders foreclosed a bond issue and formed a new corporation to which the property of the obligor was transferred and the bondholders of the old company were the controlling stockholders of the new corporation. The leading case upon the subject is the case of *Commissioner v. Kitselman*, 89 Fed. (2d) 458 (C. C. A. 7th) (certiorari denied 302 U. S. 709). This case was followed in the case of *Commissioner v. Newberry L. & C. Co.*, 94 Fed.

(2d) 447 (C. C. A. 6th). The Circuit Court of Appeals for the Second, Fifth, Sixth, Seventh and Eighth Circuits have all determined the question in favor of the taxpayer. In addition to the *Kitselman* and *Newberry* cases the following is a list of the cases so determined in the various taxpayers' favor:

Commissioner v. Southwest Consolidated Corporation, 119 Fed. (2d) 561 (C. C. A. 5th), decided April 19, 1941;

Commissioner v. Alabama Asphaltic Limestone Company, 119 Fed. (2d) 819 (C. C. A. 5th), decided May 5, 1941;

Commissioner v. New Haven and Shore Line Railway Company, Inc., ... Fed. (2d) ..... (C. C. A. (2d), decided July 21st, 1941; reported in Prentice-Hall, 1941 Fed. Tax Service, par. 62,841;

Commissioner v. James Q. Newton Trust, ... Fed. (2d) ..... (C. C. A. 10th), decided July ...., 1941.

The Circuit Court of Appeals for the Ninth Circuit struck the first discordant note when it decided the cases of *Commissioner of Internal Revenue v. Bondholders Committee, et al.*, and *Commissioner of Internal Revenue v. Marlborough House, Inc.*, 118 Fed. (2d) 511, wherein the Court held that the opinion of the Supreme Court of the United States in the *LeTulle* case contained language broad enough to overrule the *Kitselman* and *Newberry* cases, and decided the cases against the taxpayers. Then followed the opinion of the Ninth Circuit in the instant case of *Commissioner v. Palm Springs Holding Corporation*, 119 Fed. (2d) 846, in which it was held that the *Kitselman* and *Newberry* cases were overruled by the *LeTulle* and *Tyng* cases.

In the case of *Commissioner v. New Haven & Shore Line R. R. Co., supra*, the Court said:

"The crux of the case at bar is therefore whether, since the seller was definitively insolvent—that is to say, since its shares could not possibly have any value—the bondholders were to be regarded as surrendering the same interest that they got back in the form of shares in the buyer. Did the seller's insolvency provide the required 'continuity of interest'? That question has come up five times, under the Act of 1928 or the Act of 1934, either as a question of 'recognizable' gain or loss, or of depreciation. Three circuit courts of appeal have held that there was a 'reorganization'—one of them since LeTulle v. Scofield, *supra* (308 U. S. 415) was decided. Commissioner v. Kitselman, 89 F. (2d) 458 (C. C. A. 7); Commissioner v. Newberry L. & C. Co., 94 F. (2d) 447 (C. C. A. 6); Commissioner v. Southwest Consolidated Corp., 119 F. (2d) 561 (C. C. A. 5), and Commissioner v. Alabama Asphaltic Co., 119 F. (2d) 819 (C. C. A. 5). The Ninth Circuit has, however, held otherwise, Commissioner v. Marlborough House, Inc., 118 F. (2d) 511. It seems to us that the majority has been right. Certainly LeTulle v. Scofield, *supra* (308 U. S. 415), had no such question in mind, in spite of its including Commissioner v. Kitselman in the note on page 420; it very explicitly put the decision on the fact that creditors, no matter how distant might be the maturity of their debts, had no interest in the debtor's property, even though they were secured by a lien."

It is submitted that the divergence between the Ninth Circuit and the other Circuits hereinbefore mentioned could only arise because of the misconstruction of the *LeTulle* and *Tyng* cases, *supra,* by the Circuit Court of Appeals for the Ninth Circuit.

In both the *LeTulle* and *Tyng* cases, stockholders of the transferor corporations received stocks, bonds and cash of the transferee corporations and thus were converted from stockholders of the transferor corporations into creditors of the transferee corporations. No insolvent corporations were involved, consequently, there was no continuity of interest in the assets of the transferors remaining in the hands of LeTulle and Tyng. In the instant case the two old corporations were insolvent as a consequence of which the bondholders were moved up to the status of stockholders and had approximately 95% interest and control in the assets of the two old companies. They received stock in the transferee corporation for their securities in the old corporations and they retained an interest or control of over 50% in the assets. Therefore, there exists here a continuity of interest that is lacking in the *LeTulle* and *Tyng* cases. This distinction was pointed out by the Board of Tax Appeals in the case of *Commissioner v. James Q. Newton,* 42 B. T. A. 473, at 483, in which the facts are comparable to those in the case at bar. The *Newton* case has been affirmed by the Circuit Court of Appeals for the Tenth Circuit.

It should be noted that in the *LeTulle* case your Honorable Court in a footnote cited the *Kitselman* case as an example of the difficulty in classifying securities involved in various cases. (308 U. S. at p. 420.) Inferentially, it would appear from this that the Supreme Court of the United States did not regard the *LeTulle* case as overruling the *Kitselman* case.

Analyses of the *LeTulle* decision are presented in C. C. H. Illustrative Bulletin E, May 8, 1940; The Meaning of LeTulle vs. Scofield, Silverson, 18 Tax Magazine, 492 (1940), Income Tax Problems of Reorganization, Virgil S. Chandler, December, 1940, University of Kansas City Law Review, Volume IX, page 22.

The Circuit Court of Appeals for the Ninth Circuit Has Decided an Important Question of Federal Law Which Has Not Been, But Should Be, Settled by the Supreme Court of the United States.

The principle involved in the present case is one of importance to a large number of taxpayers and, it is believed, has not been passed upon by your Honorable Court and the present case presents an appropriate situation which would justify the exercise of your Honorable Court's power of supervision.

Conclusions.

Since there is a conflict between the Circuit Court of Appeals for the Ninth Circuit and five other Circuits as hereinbefore pointed out it would seem appropriate that a Writ of Certiorari should be granted to reverse the decision of the Circuit Court of Appeals for the Ninth Circuit;

FIRST, because that decision is in conflict with the decisions of five other Circuits;

SECOND, the decision of the Ninth Circuit misapplies and misconstrues the holding in *LeTulle v. Scofield* and *Commissioner v. Tyng;*

THIRD, the holding of the Ninth Circuit is in conflict with more recent cases of *Commissioner v. Alabama Asphaltic Limestone Co.; Commissioner v. Southwest Consolidated Corporation, supra,* of the Fifth Circuit; *Commissioner v. New Haven & Shore Line R. R. Co., supra,* of the Second Circuit; and *Commissioner v. James Q. Newton Trust, supra,* of the Tenth Circuit;

FOURTH, the question of law involved is in confusion and should be clarified and is of wide importance in the administration of the Revenue Laws of the United States;

FIFTH, the decision of the Ninth Circuit is a departure from the accepted and usual decisions on the subject made and should be corrected.

Respectfully submitted,

THOMAS R. DEMPSEY,
Attorney for Petitioner.

APPENDIX.

Sections of the 1936 Revenue Act, 26 U. S. C. A.

Internal Revenue Acts:

SEC. 1. APPLICATION OF TITLE.

The provisions of this title shall apply only to taxable years beginning after December 31, 1935. Income, war-profits, and excess-profits taxes for taxable years beginning prior to January 1, 1936, shall not be affected by the provisions of this title, but shall remain subject to the applicable provisions of prior Revenue Acts, except as such provisions are modified by legislation enacted subsequent to this Act. (p. 819.)

Sections of the 1934 Revenue Act, 26 U. S. C. A., Internal Revenue Acts:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(1) Depreciation.—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * * (p. 673.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) BASIS FOR DEPRECIATION.—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property. (p. 701.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(b) ADJUSTED BASIS.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided. (p. 700.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) Basis (Unadjusted) of Property. The basis of property shall be the cost of such property; except that—

(12) BASIS ESTABLISHED BY REVENUE ACT OF 1932.—If the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis thereof, for the purpose of the Revenue Act of 1932 was prescribed by section 113 (a) (6), (7), or (9) of such Act, then for the purposes of this Act the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932. (p. 700.)

Sections of the 1932 Revenue Act, 26 U. S. C. A., Internal Revenue Acts:

§114 BASIS FOR DEPRECIATION AND DEPLETION.

(a) Basis for Depreciation. The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property. (p. 519.)

§113 ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(b) Adjusted Basis. The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided. (p. 518.)

§113 ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) Basis (Unadjusted) of Property. The basis of property shall be the cost of such property; except that—

(7) Transfers to corporation where control of property remains in same persons. If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer. (p. 516.)

§112 RECOGNITION OF GAIN OR LOSS.

(a) General Rule. Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) Exchanges Solely in Kind—

* * * (3) Stock for stock on reorganization. No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(4) Same—Gain of corporation. No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(5) Transfer to corporation controlled by transferor No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. (p. 511.)

* * * * * * * * *

(i) Definition of Reorganization. As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer

by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place or organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation. (pp. 513, 514.)

(j) Definition of Control.—As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

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IN THE

Supreme Court of the United States

October Term, 1941

No. 503.

PALM SPRINGS HOLDING CORPORATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF OF PETITIONER.

THOMAS R. DEMPSEY,
1104 Pacific Mutual Building, Los Angeles,
Attorney for Petitioner.

FRANK MERGENTHALER,
548 South Spring Street, Los Angeles,
Of Counsel for Petitioner.

SUBJECT INDEX.

PAGE

Opinions of the courts below 1

Jurisdiction 2

Statement of the case 2

Specification of assigned errors to be urged 7

Questions presented 8

Summary of Argument 9

Argument 10

The Circuit Court erred in refusing to hold that the steps by which the petitioner acquired all the property of the two old corporations constituted a tax free reorganization which entitles the petitioner to use the adjusted bases of the old companies in computing its depreciation for income tax purposes 12

The LeTulle case does not overrule the Kitselman case 17

Congress has not repudiated the doctrine of the Kitselman case 19

The respondent herein has adopted a totally inconsistent position with that maintained by him in the case of Commissioner v. Kitselman 20

There was continuity of interest and control in the petitioner in the assets of the two old corporations 21

In principle there should be no distinction drawn between the buildings and the furniture and fixtures in so far as deductible depreciation is concerned 24

Conclusion 25

TABLE OF AUTHORITIES CITED.

CASES. PAGE

Commissioner v. Alabama Asphaltic Limestone Company, 119 Fed. (2d) 818, decided May 5, 1941; certiorari granted October 13, 1941 ..... 7, 14

Commissioner v. James Q. Newton Trust, ... Fed. (2d) ....., decided July 24th, 1941 ..... 14, 16

Commissioner v. Kitselman, 89 Fed. (2d) 458; certiorari denied 302 U. S. 709 ..... 7, 14, 15, 17, 19, 20, 24, 25

Commissioner v. Newberry L. & C. Co., 94 Fed. (2d) 447 ..... 7, 14, 15, 24

Commissioner v. New Haven and Shore Line Railway Company, Inc. ..... Fed. (2d) ....., decided July 16th, 1941; reported in Prentice-Hall, 1941 Fed. Tax Service, par. 62,841 ..... 14, 15

Commissioner v. Palm Springs Holding Corporation, 119 Fed. (2d) 846 15

Commissioner v. Southwest Consolidated Corporation, 119 Fed. (2d) 561, decided April 19, 1941; certiorari granted October 13, 1941 ..... 7, 14

Commissioner of Internal Revenue v. Bondholders Committee, et al., and Commissioner of Internal Revenue v. Marlborough House, Inc., 118 Fed. (2d) 511 14

Helvering v. Tyng, 308 U. S. 527 ..... 7, 15, 16

LeTulle v. Scofield, 308 U. S. 415 ..... 7, 15, 16, 17, 18, 25

MISCELLANEOUS.

PAGE

C. C. H. Illustrative Bulletin E, May 8, 1940 18

Chandler, Virgil S., Income Tax Problems of Reorganization, December, 1940, University of Kansas City Law Review, Vol. IX, p. 22 18

Paul, Randolph E., Studies in Federal Taxation, Third Series, p. 160 18

18 Tax Magazine, 492 (1940), Silverson, The Meaning of LeTulle v. Scofield 18

STATUTES.

Act of February 13, 1925, 43 Stat. 938, 28 U. S. C. A., Sec. 347(a) 2

Judicial Code, Sec. 240(a) 2

Revenue Act of 1924 Sec. 112(a) and (b) 12

Revenue Act of 1924, Sec. 113(a) (12) 12

Revenue Act of 1924, Sec. 113(b) 12

Revenue Act of 1932, Sec. 113(a) (7) 12, 21

Revenue Act of 1932, Sec. 112(i) 13, 21

Revenue Act of 1932, Sec. 112(j) 13, 21

Revenue Act of 1932, Sec. 112(i) (1) and (2) 23

Revenue Act of 1932, Sec. 114(a) 12, 23

Revenue Act of 1934, Sec. 113 12

Revenue Act of 1934, Sec. 113(a) (7) 12, 21, 23

Revenue Act of 1934, Sec. 114(a) 12

Revised Statutes, Sec. 1008 as amended (28 U. S. C. A., Sec. 350) 2

INDEX TO APPENDIX

PAGE

Sections of the 1936 Revenue Act, 26 U. S. C. A. 27

Section 1 27

Section 23 27

Section 113 28

Section 114 27

Sections of the 1932 Revenue Act, 26 U. S. C. A., Internal Revenue Acts 28

Section 112 29

Section 113 29

Section 114 28

Committee reports 31

IN THE

Supreme Court of the United States

October Term, 1941

No. 503.

PALM SPRINGS HOLDING CORPORATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF OF PETITIONER.

Opinions of the Courts Below.

The opinion of United States Board of Tax Appeals in this case is an unreported memorandum decision. [R. 30.] This decision was favorable to the petitioner with respect to depreciation upon buildings and favorable to the respondent with respect to depreciation on furniture and fixtures.

The judgment of the Circuit Court of Appeals for the Ninth Circuit is dated May 14, 1941, and is reported in 119 Fed. (2d) 846. [R. 88.] That decision was adverse to the petitioner.

Jurisdiction.

I.

The jurisdiction of this Court is invoked upon the grounds (1) that there is a conflict between the Circuit Court of Appeals for the Ninth Circuit and five other Circuits with respect to the questions here involved, and (2) that a question of law of wide importance in the administration of the Revenue Laws of the United States is in confusion and should be clarified.

II.

The jurisdiction of this Court is further invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925, 43 Stat. 938, 28 U. S. C. A. Sec. 347(a); Rev. Stat. Sec. 1008 as amended (28 U. S. C. A. Sec. 350).

III.

The Supreme Court of the United States has heretofore granted a Writ of Certiorari herein directed to the United States Circuit Court of Appeals for the Ninth Circuit.

Statement of the Case.

A corporation known as the Palm Spring Hotel Co. owned a hotel. In July, 1932, the corporation had outstanding $309,000 of its first mortgage bonds which were a lien upon the hotel property. The hotel was leased to another company known as the El Mirador Hotel Operating Co., which owned the furniture and fixtures. To secure the performance of the terms of the lease, the El Mirador Hotel Operating Co. gave a chattel mortgage upon the said furniture and fixtures to the said Palm

Springs Hotel Co. This latter company in turn pledged the lease and chattel mortgage as part of the security for its said bond issue. [R. 23.]

In the spring of 1931 both the Palm Springs Hotel Co. and the El Mirador Hotel Operating Co. were in financial difficulties and were unable to meet their respective obligations, having sustained large operating deficits. [R. 24.] Under date of August 20, 1931, a bondholders protective committee for Palm Springs Hotel Co. first mortgage seven per cent s. f. gold bonds was formed to protect the interests of the holders of said bonds. [R. 25.] A copy of the bondholders' deposit agreement is set forth at pages 70 to 73 of the record.

The petitioner was formed under the laws of the State of California on April 1, 1932 [R. 22 and 25], pursuant to a plan of reorganization for the purpose of acquiring said bonds and ultimately all of the properties of said Palm Springs Hotel Co. and of the El Mirador Hotel Operating Co. During the month of May, 1932, the petitioner issued all of its preferred shares and part of its common shares in exchange for $292.000.00 par value of said bonds. [R. 26.] The remainder of its common shares were issued to R. D. Lacoe in consideration for his agreement to pay up to $1.000.00 the cost of incorporating the petitioner and for his agreement to lend moneys to the petitioner. Lacoe was also a holder of a large block of the bonds for which the other shares were issued. [R. 26 and 27.]

On or about July 15, 1932, petitioner was the successful bidder at a Trustee's sale of all of the properties of Palm Springs Hotel Co. held pursuant to the terms of

the indenture securing said bonds. The bid price was $61,800.00, which was paid as follows:

(a) Payment of cash amounting to	$18,767.96
(b) By the delivery to the Trustee of bonds of Palm Springs Hotel Co. having a face value of $292,000.00 for the balance of	43,032.04
	$61,800.00

The said properties were acquired subject to obligations prior to the lien of the bonds amounting to $38,949.76, of which amount $13,500.00 constituted a lien against furniture and fixtures. [R. 27 and 28.]

Among the assets acquired by the petitioner at the Trustee's sale were the said lease, the indebtedness thereon and the said chattel mortgage. [R. 27 and 28.]

On August 2, 1932, the taxpayer foreclosed on the chattel mortgage on the furniture and fixtures. [R. 28.] At the foreclosure sale the furniture and fixtures were sold to the taxpayer pursuant to a decree of foreclosure for a bid price of $20,179.25. [R. 28.] The amount of the judgment for the indebtedness of the El Mirador Hotel Operating Co. under the lease and chattel mortgage was $77,918.79. [R. 28.] The furniture and fixtures constituted all of the properties of the El Mirador Hotel Operating Co. [R. 27.]

The properties formerly owned by Palm Springs Hotel Co. and acquired by petitioner as aforesaid constituted what is known as the El Mirador Hotel at Palm Springs, California. [R. 23.]

All of the capital stock of Palm Springs Hotel Co. and El Mirador Hotel Operating Co., excepting in each case

ten (10) shares of capital stock owned by Warren B. Pinney, who was president of both companies, had been forfeited for nonpayment of assessments levied against the shares, so that at the time petitioner was organized said Pinney was the sole stockholder of both corporations. [R. 24 and 25.] Said Pinney received no capital stock of petitioner for his holding of capital stock of either of the two predecessor corporations; nor did any other stockholders of such corporations receive any shares of petitioner for any rights which they may have had as such stockholders. [R. 30.] Said Pinney received 1,000 shares of common stock of petitioner for his services in the reorganization and as an inducement to continue as manager of the Hotel. [R. 29.]

The petitioner on its Federal income tax return for the fiscal year ended May 31, 1936, deducted depreciation upon the hotel buildings and the furniture and fixtures and upon the bases of the two predecessor corporations. [R. 15.] The cost to Palm Springs Hotel Co., including all additions up to July 15, 1932, of the buildings which were acquired by petitioner as aforesaid was $686,731.97. Subsequently the petitioner, up to May 31, 1936, expended $82,652.81 for additions to said buildings. The useful life of the buildings was twenty years from January 1, 1928. [R. 29.]

The cost of El Mirador Hotel Operating Co., including all additions up to August 2, 1932, of the furniture and fixtures acquired by petitioner on the date named was $232,544.10. Subsequently petitioner acquired additional furniture and fixtures up to May 31, 1936, at a cost of $40,485.18. The useful life of said furniture and fixtures was twelve years from the date of acquisition new. [R. 29.]

Upon the examination of the return, the Commissioner of Internal Revenue disallowed the depreciation upon the basis mentioned and based his determination of deductible depreciation upon the said furniture and fixtures for income tax purposes upon what he claimed to be the fair market value thereof as of the date of foreclosure of the chattel mortgage. [R. 15.]

The amount of depreciation claimed by the petitioner upon the buildings was $51,955.72 based upon their cost to petitioner's predecessor corporation. [R. 13 and 15.] The amount of depreciation allowed by the Commissioner upon the buildings was $17,513.60 [R. 15] based on a valuation report as of date of acquisition, with the cost of improvements and additions added. [R. 13.]

The amount of depreciation claimed by the petitioner upon the furniture and fixtures was $32,083.57 based upon the cost of the same to the predecessor corporation. [R. 13 and 15.] The amount of depreciation allowed by the Commissioner upon the furniture and fixtures was $15,892.97 [R. 15] based on a valuation report as of date of acquisition, with the cost of improvements and additions added. [R. 13.]

The petitioner appealed to the United States Board of Tax Appeals from the Commissioner's determination. [R. 4.] The Board of Tax Appeals decided the issue of depreciation with respect to the buildings in favor of the petitioner, holding that the petitioner was entitled to use its predecessor's adjusted cost, and decided the issue of depreciation with respect to the furniture and fixtures in favor of the Commissioner of Internal Revenue, the respondent herein. [R. 33, 34 and 35.]

Both the petitioner and the respondent herein sought reviews of the decision of the United States Board of Tax Appeals. [R. 36 and 46.]

The Circuit Court of Appeals resolved both issues in favor of the Commissioner. [R. 95.]

The petitioner sought, and was granted, a writ of certiorari herein to review the decision of the United States Circuit Court of Appeals for the Ninth Circuit.

Specification of Assigned Errors to Be Urged.

1. The Circuit Court of Appeals for the Ninth Circuit erred in refusing to hold that the steps taken by the petitioner in acquiring the assets of the Palm Springs Hotel Co. and the El Mirador Hotel Operating Co. constituted a tax free reorganization whereby the petitioner as a party to the reorganization is entitled to the same basis for depreciation as the predecessor insolvent corporations.

2. The Circuit Court of Appeals for the Ninth Circuit erred in refusing to hold that this case is governed by the cases of *Commissioner v. Newberry L. & C. Co.*, 94 Fed. (2d) 447 (C. C. A. 6th); *Commissioner v. Kitselman*, 89 Fed. (2d) 458 (C. C. A. 7th); *Commissioner v. Southwest Consolidated Corporation*, 119 Fed. (2d) 561 (C. C. A. 5th), and *Commissioner v. Alabama Asphaltic Limestone Company, Inc.*, 119 Fed. (2d) 819 (C. C. A. 5th).

3. The Circuit Court of Appeals for the Ninth Circuit erred in holding that the cases of *LeTulle v. Scofield*, 308 U. S. 415, and *Helvering v. Tyng*, 308 U. S. 527, overruled the cases of *Newberry* and *Kitselman*, *supra*.

4. The Circuit Court of Appeals for the Ninth Circuit erred in rejecting the petitioner's contention that immediately after the above mentioned transfer an interest or control in the transferred property of 50 per centum or more remained in the same persons as before the transfer.

5. The Circuit Court of Appeals for the Ninth Circuit erred in holding that prior to the transfer the taxpayer had no interest or control in any of the property but was merely a creditor of the Hotel Company and the Operating Company.

6. The Circuit Court of Appeals for the Ninth Circuit erred in holding that the basis of the petitioner for the real and personal property was the cost thereof to the petitioner.

Questions Presented.

1. DID THE PETITIONER ACQUIRE ITS HOTEL BUILDING IN CONNECTION WITH A TAX FREE REORGANIZATION WHICH ENTITLES IT TO USE THE ADJUSTED BASIS OF ITS PREDECESSOR CORPORATION PLUS ADDITIONS FOR THE PURPOSE OF COMPUTING DEDUCTIBLE DEPRECIATION FOR INCOME TAX PURPOSES?

2. DID THE PETITIONER ACQUIRE THE HOTEL FURNITURE AND FIXTURES IN CONNECTION WITH A TAX FREE REORGANIZATION WHICH ENTITLES IT TO USE THE ADJUSTED BASIS OF ITS PREDECESSOR CORPORATION PLUS ADDITIONS FOR THE PURPOSE OF COMPUTING DEDUCTIBLE DEPRECIATION FOR INCOME TAX PURPOSES?

Summary of Argument.

The Palm Springs Hotel Co. and the El Mirador Hotel Operating Co. in 1932 were insolvent. The petitioner was the owner of approximately 95% of the outstanding bonds of the Palm Springs Hotel Co. which were a lien upon all of the property of the Palm Springs Hotel Co. By virtue of a trustee's sale under the bond issue, the petitioner acquired the chattel mortgage, lease and indebtedness of the El Mirador Hotel Operating Co. Owing to the insolvency of these two companies and the superior position of the petitioner as a holder of the bonds and chattel mortgage the petitioner was, to all practical effects and purposes, a stockholder of the two companies, owning an interest or control in excess of 95% of the assets in both companies because of the disappearance of the equities of the stockholders in the two predecessor corporations. Since the petitioner ultimately acquired all of the assets of the two companies by the issuance of its stock and the petitioner's stockholders were the virtual stockholders of the two predecessor companies, the steps by which it acquired all of the assets of the two old companies constituted a tax free reorganization and consequently petitioner is entitled to use the adjusted basis of the two old companies for the purpose of computing depreciation for income tax purposes.

Argument.

The question involved in this proceeding is the proper basis for computing depreciation upon the buildings, furniture and fixtures of the petitioner for income tax purposes for the fiscal year ended May 31, 1936. The petitioner contends that it has the right to compute its depreciation upon the adjusted basis of its predecessor corporations plus cost of additions. The respondent, on the other hand, contends that the petitioner is entitled to deduct depreciation upon the fair value of the assets as of date of acquisition by the petitioner plus cost of additions.

The petitioner held $292,000.00 par value out of $309,000.00 par value of the outstanding first mortgage bonds of the Palm Springs Hotel Co. [R. 23 and 26.] This was approximately 95% of the entire issue. These bonds were secured by an indenture which was a lien upon all of the assets of the obligor. [R. 23.] The Palm Springs Hotel Co. had leased the building to the El Mirador Hotel Operating Co., which latter company was the lessee of the hotel building. [R. 23.] The latter company gave to the Palm Springs Hotel Co. a chattel mortgage on its furniture and fixtures to secure the performance of the terms of the lease. [R. 23.] The Palm Springs Hotel Co. in turn pledged this lease and chattel mortgage as additional security under the indenture securing the bonds. [R. 23.] The Palm Springs Hotel Co. and the El Mirador Hotel Operating Co. were insolvent in 1932 [R. 24], at which time the petitioner was the owner of approximately 95% of the outstanding bonds. All except ten shares of the stock of each of the Palm Springs Hotel Co. and the El Mirador Hotel Operating Co. had been sold for assessments and each company.

bought in all of its respective shares except ten shares in each company which were retained by W. B. Pinney, who then became the sole stockholder in each of the two old companies. [R. 24 and 25.] This sole stockholder became a stockholder of the petitioner. [R. 29.]

In 1932 the trustee under the trust indenture sold all of the properties of the Palm Springs Hotel Co. including the chattel mortgage and lease to the petitioner who bid $61,800.00 for the said assets. This bid was paid as follows:

Cash	$18,767.96
Bonds of Palm Springs Hotel Co. of the par value of $292,000	43,032.04
	$61,800.00 [R. 27.]

Thereafter the petitioner foreclosed the chattel mortgage given by the El Mirador Hotel Operating Co. in a court proceeding in which the petitioner procured a judgment of $77,918.79 on the said lease. The furniture and fixtures of the El Mirador Hotel Operating Co. were sold to the petitioner under said judgment for $20,179.25. These furniture and fixtures constituted all of the assets of the El Mirador Hotel Operating Co. [R. 28.]

All of said assets were acquired by the petitioner pursuant to a Plan of Reorganization which is set forth in a copy of the Bondholders' Protective Agreement. [R. 70-73 incl. and 78-81 incl.]

The petitioner was entitled to deduct upon its Federal income tax return for its fiscal year ended May 31, 1936, depreciation upon its properties for income tax purposes. This deduction is provided for by Section 23 of the

Revenue Act of 1934. [See Appendix for Statutes.] The controversy here arises over the basis to be used for that purpose. The petitioner claims the right to use the adjusted basis of the two old corporations whereas the Commissioner contends that the basis should be the fair market value as of the date of foreclosure. [R. 15.]

The Circuit Court Erred in Refusing to Hold That the Steps by Which the Petitioner Acquired All the Property of the Two Old Corporations Constituted a Tax Free Reorganization Which Entitles the Petitioner to Use the Adjusted Bases of the Old Companies in Computing Its Depreciation for Income Tax Purposes.

Under Section 113 of the Revenue Act of 1934 [see Appendix] the cost of property is the normal basis for computing depreciation. There are exceptions to this rule and it is the contention of the petitioner that the Circuit Court failed to follow a long line of decisions holding that similar transactions resulted in tax free reorganizations which give rise to one of the exceptions mentioned. Reference to Sections 114 (a) and 113 (a) (12) and 113 (b) of the Revenue Act of 1934 will disclose that the provisions of Section 112 (a) and (b), Section 113 (a) (7), and Section 114 (a) of the Revenue Act of 1932 govern the basis upon which the petitioner claims the right to compute depreciation for income tax purposes. [See Appendix.]

Section 113 (a) (7) of the Revenue Act of 1932, in effect, provides that if property was acquired after December 31, 1917, by a corporation in connection with a reorganization and immediately after the transfer of an interest or control of such property of 50% or more

remained in the same persons or any of them the basis for depreciation shall be the same as it would be in the hands of the transferor, with certain adjustments.

Section 112 (i) of the same Act defines the term "reorganization" as, among other things: (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred.

This section defines further the term "a party to a reorganization" as to include both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

Subsection (j) of the same section defines the word "control" as meaning at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

The petitioner's application for a Writ of Certiorari was grounded upon the fact that a number of cases in which the factual situations are very similar to the one at bar have been passed upon in the Circuit Courts of Appeals in at least six Circuits. With the exception of the Ninth Circuit, all of the Circuits in which the cases have arisen have held that a tax free reorganization resulted where bondholders foreclosed a bond issue and

formed a new corporation to which the property of the obligor was transferred and the bondholders of the old company were the controlling stockholders of the new corporation. The leading case upon the subject is the case of *Commissioner v. Kitselman*, 89 Fed. (2d) 458 (C. C. A. 7th) (certiorari denied 302 U. S. 709). This case was followed in the case of *Commissioner v. Newberry L. & C. Co.*, 94 Fed. (2d) 447 (C. C. A. 6th). The Circuit Court of Appeals for the Second, Fifth, Sixth, Seventh and Tenth Circuits have all determined the question in favor of the taxpayers. In addition to the *Kitselman* and *Newberry* cases the following is a list of the cases so determined in the various taxpayers' favor:

Commissioner v. Southwest Consolidated Corporation, 119 Fed. (2d) 561 (C. C. A. 5th), decided April 19, 1941; certiorari granted October 13, 1941;

Commissioner v. Alabama Asphaltic Limestone Company, 119 Fed. (2d) 818 (C. C. A. 5th), decided May 5, 1941; certiorari granted October 13, 1941;

Commissioner v. New Haven and Shore Line Railway Company, Inc., ... Fed. (2d) ..... (C. C. A. (2d), decided July 16th, 1941; reported in Prentice-Hall, 1941 Fed. Tax Service, par. 62,841;

Commissioner v. James Q. Newton Trust, ... Fed. (2d) ..... (C. C. A. 10th), decided July 24th, 1941.

The Circuit Court of Appeals for the Ninth Circuit struck the first discordant note when it decided the cases of *Commissioner of Internal Revenue v. Bondholders Committee, et al.*, and *Commissioner of Internal Revenue v. Marlborough House, Inc.*, 118 Fed. (2d) 511, wherein

the Court held that the opinion of the Supreme Court of the United States in the *LeTulle* case contained language broad enough to overrule the *Kitselman* and *Newberry* cases, and decided the cases against the taxpayers. Then followed the opinion of the Ninth Circuit in the instant case of *Commissioner v. Palm Springs Holding Corporation*, 119 Fed. (2d) 846, in which it was held that the *Kitselman* and *Newberry* cases were overruled by the *LeTulle* and *Tyng* cases.

In the case of *Commissioner v. New Haven & Shore Line R. R. Co.*, *supra*, the Court said:

> "The crux of the case at bar is therefore whether, since the seller was definitely insolvent—that is to say, since its shares could not possibly have any value—the bondholders were to be regarded as surrendering the same interest that they got back in the form of shares in the buyer. Did the seller's insolvency provide the required 'continuity of interest'? That question has come up five times, under the Act of 1928 or the Act of 1934, either as a question of 'recognizable' gain or loss, or of depreciation. Three circuit courts of appeal have held that there was a 'reorganization'—one of them since LeTulle v. Scofield, *supra* (308 U. S. 415) was decided. Commissioner v. Kitselman, 89 F. (2d) 458 (C. C. A. 7); Commissioner v. Newberry L. & C. Co., 94 F. (2d) 447 (C. C. A. 6); Commissioner v. Southwest Consolidated Corp., 119 F. (2d) 561 (C. C. A. 5), and Commissioner v. Alabama Asphaltic Co., 119 F. (2d) 819 (C. C. A. 5). The Ninth Circuit has, however, held otherwise. Commissioner v. Marlborough House, Inc., 118 F. (2d) 511. It seems to us that the majority has been right. Certainly LeTulle v. Scofield, *supra* (308 U. S. 415), had no such question in mind,

in spite of its including Commissioner v. Kitselman in the note on page 420; it very explicitly put the decision on the fact that creditors, no matter how distant might be the maturity of their debts, had no interest in the debtor's property, even though they were secured by a lien."

It is submitted that the divergence between the Ninth Circuit and the other Circuits hereinbefore mentioned could only arise because of the misconstruction of the *LeTulle* and *Tyng* cases, *supra*, by the Circuit Court of Appeals for the Ninth Circuit.

In both the *LeTulle* and *Tyng* cases, stockholders of the transferor corporations received stocks, bonds and cash of the transferee corporations and thus were converted from stockholders of the transferor corporations into creditors of the transferee corporations. No insolvent corporations were involved, consequently, there was no continuity of interest in the assets of the transferors remaining in the hands of LeTulle and Tyng. In the instant case the two old corporations were insolvent as a consequence of which the bondholders were moved up to the status of stockholders and had approximately 95% interest and control in the assets of the two old companies. They received stock in the transferee corporation for their securities in the old corporations and they retained an interest or control of over 50% in the assets. Therefore, there exists here a continuity of interest that is lacking in the *LeTulle* and *Tyng* cases. This distinction was pointed out by the Board of Tax Appeals in the case of *Commissioner v. James Q. Newton*, 42 B. T. A. 473, at 483, in which the facts are comparable to those in the case at bar. The *Newton* case has been affirmed by the Circuit Court of Appeals for the Tenth Circuit.

The LeTulle Case Does Not Overrule the Kitselman Case.

The contention of the respondent before the Circuit Court of Appeals was that the *LeTulle* case overruled the *Kitselman* case by implication. As hereinbefore pointed out, in the *LeTulle* case the stockholder of the transferor company received bonds of the transferee corporation and therefore became a creditor in the new company, whereas he was a stockholder in the old company. In the instant case the bondholders of an insolvent corporation, having a control or interest in the assets of the old company, exchanged their bonds for stock in the transferee corporation, thus maintaining the continuity of interest, which was lacking in the *LeTulle* case. In the *LeTulle* case the Court said:

> "Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise. On the contrary, he becomes a creditor of the transferee; and we do not think that the fact referred to by the Circuit Court of Appeals, that the bonds were secured solely by the assets transferred and that upon default, the bondholder would retake only the property sold, changes his status from that of a creditor to one having a proprietary stake, within the purview of the statute."

Certainly the Second, Fifth and Tenth Circuits, as hereinbefore pointed out, have held that the *Kitselman* case is not overruled by the *LeTulle* case. It will be noted that the Supreme Court of the United States in footnote

7 to the *LeTulle* opinion cited the *Kitselman* case as an example of the difficulty in classifying securities. It would seem somewhat strange that the Court would cite the *Kitselman* case in a footnote to the *LeTulle* case if it had intended to overrule it. If anything it would appear that such a citation would rather imply an approval of the case.

Randolph E. Paul in his *Studies in Federal Taxation*, Third Series, at page 160, says:

> "There would seem to be no reason for interpreting the LeTulle case as casting doubt upon the Kitselman doctrine. The LeTulle case merely decides that bondholders in a solvent corporation, since they are not the equity proprietors, cannot be the conduit for the requisite continuing interest. But the all-important fact of the insolvency of the old corporation, causing the bondholders to replace the shareholders as owners of the proprietary interest, was wholly absent in the LeTulle case. Where, on the other hand, the bondholders step into the shoes of the stockholders by reason of insolvency, and acquire stock in the new company in exchange for their interest in the old, no collision with the LeTulle principle is present."

Analyses of the *LeTulle* decision are presented in C. C. H. Illustrative Bulletin E, May 8, 1940; The Meaning of *LeTulle v. Scofield, Silverson*, 18 Tax Magazine, 492 (1940), Income Tax Problems of Reorganization, Virgil S. Chandler, December 1940, University of Kansas City Law Review, Volume IX, page 22.

Congress Has Not Repudiated the Doctrine of the Kitselman Case.

The *Kitselman* case was decided April 12, 1937, by the United States Circuit Court of Appeals for the Seventh Circuit and, with the exception of the Ninth Circuit Court of Appeals, it has been followed consistently by other circuits and by the United States Board of Tax Appeals in cases involving the same issues. Since the decision of the *Kitselman* case Congress has adopted several Revenue Acts, to-wit: The Acts of 1938, 1939, 1940 and 1941, but in none of these Acts has Congress repudiated the doctrine of the *Kitselman* case.

The *Kitselman* case is not an obscure authority. On the contrary it has been the subject of much discussion in the field of tax law and it can scarcely be contended that it has escaped the notice of Congress. It would seem reasonable to suppose that since Congress has taken no legislative action to overcome the effect of the case, taxpayers are entitled to assume that Congress approves the *Kitselman* doctrine. Even prior to the decision of the *Kitselman* case, Congress appears to have approved of the principle as will appear from the Ways and Means Committee report of the House of Representatives published in CB 1939-1 Part 2, pages 564 and 565, extracts of which are set forth in the Appendix hereto, and as further appears from the report of the Senate Committee on Finance published in CB 1939-1 Part 2, pages 598 and 599, also set forth in the Appendix hereto.

The Respondent Herein Has Adopted a Totally Inconsistent Position With That Maintained by Him in the Case of Commissioner v. Kitselman.

In the *Kitselman* case (*supra*) a bondholder of a corporation sought to deduct a loss upon the exchange of his bonds in the corporation for stock of another corporation which was formed for the purpose of acquiring the old corporation's assets at a foreclosure on the bond issue. In that case the Commissioner vigorously and successfully maintained that the bondholder was not entitled to a deduction for the reason that the exchange of the bonds of the old company for the stock of the new company was in connection with a tax free reorganization and under the appropriate provisions of the Revenue law no loss could be recognized. The taxpayer sought a Writ of Certiorari, which was denied by your Honorable Court, 302 U. S. 709. The petitioner is informed that in the Commissioner's brief filed on November 2, 1936, in the Seventh Circuit Court, case No. 6022, *Commissioner v. Kitselman*, the Commissioner argued at page 17 of the brief as follows:

> "Under these decisions, it is submitted, for reorganization purposes, a bondholder stands in no different position from a stockholder with respect to an interest in the assets and affairs of a corporation and where, as in the present case, the bondholders were the only parties in interest in the assets of an insolvent corporation, a continuity of their (the bondholders) interest in the assets in the hands of a new corporation is a sufficient compliance with the requirements of the statute. That these bondholders were the only real parties in interest will be realized when it is observed that upon the foreclosure sale all the properties of the old corporation brought only

'$430,000 free and clear of all liens and encumbrances, except the lien of any taxes, assessments, and water rents lawfully levied or assessed, and also the lien of the first mortgage securing the I. Rv. Co. bonds not in default' [R. 32-33], and that the defaulting bond issues under which these assets were sold amounted to the total sum of $3,989,000 [R. 31]."

And at page 18:

"It is also plain, we submit, that merely because one of the steps in the plan of reorganization as formulated and executed consisted of foreclosure proceedings and a judicial sale of the mortgaged assets prior to transfer to a new corporation formed for that purpose, such procedure will not defeat what may otherwise be regarded as a statutory reorganization. It will also be observed that this procedure was taken 'at the instigation of the committee, in pursuance of the plan and agreement' [R. 32]. It has long been established that acquisition of assets through the medium of foreclosure proceedings does not of itself take the transfer out of reorganization provisions."

There Was Continuity of Interest and Control in the Petitioner in the Assets of the Two Old Corporations.

Under the provisions of Section 113 (a) (7), if property was acquired after December 31, 1917, by a corporation in connection with a reorganization and immediately after the transfer of an interest or control of such property of 50% or more remained in the same persons or any of them the basis for depreciation is the same as it would be in the hands of the transferor, with certain adjustments not here applicable. [See Appendix. Section 112 (i) (1) (2) (j) defines the term "reorganization."]

In the present case the issue boils down to whether or not the petitioner was the owner, prior to the foreclosure, of an interest or control in the assets of the Palm Springs Hotel Co. and El Mirador Hotel Operating Co. Upon this point it is significant to note that before the Trustee's sale under the bond issue the stockholders of both companies, with the exception of Warren B. Pinney who held 10 shares in each company, had lost their stock in both companies by virtue of nonpayment of assessments against the stock. [R. 25.] At the time of the sale under the trust indenture, to-wit, May 21, 1932 [R. 27], the stockholders of the two old companies were utterly without a voice as to what should be done with the properties of the two old corporations. They had lost their interest or equity in the assets by virtue of the insolvency of the companies. At that time the only interest or control in the assets of both companies resided in the bondholders of the Palm Springs Hotel Co. The petitioner was then the owner of aproximately 95% of those bonds. [R. 23 and 26.] Among the assets pledged to secure that bond issue were the lease and chattel mortgage of the El Mirador Hotel Operating Co., which was heavily indebted under the terms of the lease. The stockholders of the El Mirador Hotel Operating Co. had no more to say about the furniture and fixtures than those at the Palm Springs Hotel Co. had to say about its buildings. The only interest and control in those assets that existed were vested in the petitioner by reason of its ownership of the bonds of Palm Springs Hotel Co. Without any interference on

the part of either of the two old corporations the petitioner proceeded to take over the assets of both corporations by virtue of the bond issue.

It would ignore the legal and practical aspects of the situation to say that the stockholders of the two old corporations retained the slightest interest in the assets. At the time of the sale the petitioner was the only one who had any interest or control in those assets and since it acquired all of the assets of both old corporations it would clearly appear that under Section 112 (i) (1) and (2) of the Revenue Act of 1932 a tax free reorganization was consummated and that the basis for depreciation must be sought for in the provisions of Sections 113 (a) (7) and 114 (a) of the Act of 1932. These sections are set out in the Appendix.

They provide, in effect, that the basis for depreciation in the case of a tax free reorganization shall be the same as that of the transferor with certain adjustments not here applicable.

Since the petitioner contends that it acquired the assets of the two predecessor corporations in a tax free reorganization, it follows that it is entitled to use these adjusted bases in determining the amount of depreciation on these assets for the purpose of computing the petitioner's income tax.

In Principle There Should Be No Distinction Drawn Between the Buildings and the Furniture and Fixtures in so Far as Deductible Depreciation Is Concerned.

As hereinbefore pointed out the Board of Tax Appeals on the strength of the cases of *Commissioner v. Kitselman* and *Commissioner v. Newberry L. & C. Co.* (*supra*) has held that the petitioner was entitled to deduct depreciation on the hotel buildings on the adjusted basis of the Palm Springs Hotel Co., whereas with respect to depreciation on the furniture and fixtures it could deduct depreciation based on cost to the petitioner. The rights of the petitioner in respect to the buildings and the furniture and fixtures were derived by virtue of its ownership of the bonds of the Palm Springs Hotel Co. These bonds were secured by an indenture covering all of the assets of the Palm Springs Hotel Co. [R. 23 and 27.] Among those assets was the lease of the hotel to El Mirador Hotel Operating Co. This lease was secured by a chattel mortgage on the furniture and fixtures [R. 23] and this chattel mortgage was part of the assets which were secured by the indenture of the Palm Springs Hotel Co. [R. 23.] By virtue of the indebtedness of the El Mirador Hotel Operating Co. under the terms of the lease to the Palm Springs Hotel Co., which in turn was virtually owned or controlled by the petitioner herein, by reason of its ownership of the bonds of Palm Springs Hotel Co., the petitioner was virtually the owner of the entire interest and control of the furniture and fixtures in question. It is true that it was one step removed from those items of personal property, but it was the only one who had any control over them, and having acquired the lease and chattel mortgage at the Trustee's sale on the bond issue [R.

27] it proceeded to foreclose the chattel mortgage in a court action and acquired those assets. [R. 28.] As far as practical effects were concerned the Palm Springs Hotel Co. itself might just as well have been the owner of the furniture and fixtures. Consequently, it is the contention of the petitioner that no distinction should be made between the buildings and the furniture and fixtures in so far as the basis for the computation of depreciation is concerned for income tax purposes.

Conclusion.

It is respectfully submitted that the petitioner acquired the assets of the two old corporations in a tax free reorganization which entitled it to use the adjusted basis of the old corporations in computing depreciation for the purpose of income tax and that the Ninth Circuit Court of Appeals was in error in holding that the *LeTulle* case overruled the *Kitselman* case and in giving judgment against the petitioner.

It is further respectfully submitted that the judgment of the Circuit Court of Appeals should be reversed.

THOMAS R. DEMPSEY,
1104 Pacific Mutual Building, Los Angeles, California,
Attorney for Petitioner.

FRANK MERGENTHALER,
548 South Spring Street, Los Angeles, California,
Of Counsel for Petitioner.

APPENDIX.

Sections of the 1936 Revenue Act, 26 U. S. C. A.

Internal Revenue Acts:

SEC. 1. APPLICATION OF TITLE.

The provisions of this title shall apply only to taxable years beginning after December 31, 1935. Income, war-profits, and excess-profits taxes for taxable years beginning prior to January 1, 1936, shall not be affected by the provisions of this title, but shall remain subject to the applicable provisions of prior Revenue Acts, except as such provisions are modified by legislation enacted subsequent to this Act. (p. 819.)

Sections of the 1934 Revenue Act, 26 U. S. C. A., Internal Revenue Acts:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(1) Depreciation.—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * * (p. 673.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) BASIS FOR DEPRECIATION.—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property. (p. 701.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(b) ADJUSTED BASIS.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided. (p. 700.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) Basis (Unadjusted) of Property. The basis of property shall be the cost of such property; except that—

(12) BASIS ESTABLISHED BY REVENUE ACT OF 1932.—If the property was acquired after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis thereof for the purpose of the Revenue Act of 1932 was prescribed by section 113 (a) (6), (7), or (9) of such Act, then for the purposes of this Act the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932. (p. 700.)

Sections of the 1932 Revenue Act, 26 U. S. C. A., Internal Revenue Acts:

§114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) Basis for Depreciation. The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property. (p. 519.)

§113 ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(b) Adjusted Basis. The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided. (p. 518.)

§113 ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) Basis (Unadjusted) of Property. The basis of property shall be the cost of such property; except that—

(7) Transfers to corporation where control of property remains in same persons. If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer. (p. 516.)

§112 RECOGNITION OF GAIN OR LOSS.

(a) General Rule. Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) Exchanges Solely in Kind—

* * * (3) Stock for stock on reorganization. No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(4) Same—Gain of corporation. No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(5) Transfer to corporation controlled by transferor. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. (p. 511.)

* * * * * * * * *

(i) Definition of Reorganization. As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer

by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place or organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation. (pp. 513, 514.)

(j) Definition of Control.—As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

COMMITTEE REPORTS.

The Ways and Means Committee (Report published in C. B. 1939—1, Part 2, pp. 564, 565), after stating astute lawyers had taken advantage of the reorganization provisions by "arranging in the technical form of reorganization, within the statutory definition, what were really sales," said:

"By these limitations the committee believes that it has removed the danger that taxable sales can be cast into the form of a reorganization, while at the same time, legitimate reorganizations, required in order to strengthen the financial condition of the corporation, will be permitted. Furthermore, the retention of the reorganization

provisions will prevent large losses from being established by bondholders and stockholders who receive securities in a newly reorganized enterprise which are substantially the same as their original investments. * * * Likewise, many corporations have defaulted upon the dividends on their cumulative preferred stock, or upon the interest on their bonds. *These corporations,* in order to obtain necessary credit from the banks, *are arranging with* their preferred stockholders to accept new common stock and with *their bondholders to accept noncumulative preferred* stock or *bonds now held.* If the reorganization provisions were omitted from the bill, these stockholders *and bondholders* could take large losses, *although they still retain an interest in the corporation.* Although the losses in the cases given would be subject to the new limitations the committee has placed upon the deduction of capital losses, the net result, during the next year or more, of omitting the reorganization provisions might be a loss of taxes to the Treasury. The Committee, therefore, has decided that the reorganization provisions should be retained, but with restrictions to make tax avoidance impossible." (Italics supplied.)

The Senate Finance Committee said (C. B. 1939—1, Part 2, at pp. 598, 599):

"In the second place, the House bill eliminates from the definition of 'reorganization' as it appears in the present law the parenthetical phrase appearing after the words 'merger or consolidation,' which reads as follows: '(including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation).'

The House report states:

"'In the second place, the definition of a reorganization has been restricted so that the definition will conform more closely to the general requirements of corporation law, and will limit reorganizations to (1) statutory mergers and consolidations; (2) transfers to a controlled corporation, 'control' being defined as an 80 per cent ownership; and (3) changes in the capital structure or form of organization.'

"By these limitations the committee believes that it has removed the danger that taxable sales can be cast into the form of a reorganization, while at the same time, legitimate reorganizations, required in order to strengthen the financial condition of the corporation will be permitted. *Furthermore, the retention of the other reorganization provisions will prevent large losses from being established by bondholders* and stockholders *who receive securities in a newly reorganized enterprise which are substantially the same as their original investments.*

"Your committee is in complete agreement with the purposes of the House bill which aim at tax-avoidance schemes in this connection. However, some modifications are recommended in order to bring about a more uniform application of the provisions in all 48 of the States. Not all of the States have adopted statutes providing for mergers or consolidations; and, moreover, a corporation of one State can not ordinarily merge with a corporation of another State. The committee believes that it is desirable to permit reorganizations in such cases, with restrictions designed to prevent tax avoidance. Consequently, the committee recommends the insertion in the House bill

of an addition to the definition of the term 'reorganization' as follows:

"'(*B*) the acquisition by one corporation in exchange solely for its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation;'

"The committee believes that these transactions, when carried out as prescribed in this amendment, are in themselves sufficiently similar to mergers and consolidations as to be entitled to similar treatment. It will be noted that the proposed amendment requires that (1) the acquiring corporation must obtain at least 80 per cent of the voting stock and at least 80 per cent of the total number of shares of all other classes of stock of the other corporation. Instead of only a majority as provided by the present law; and (2) the acquisition, whether of stock or of substantially all the properties, must be in exchange solely for the voting stock of the acquiring corporation.

"Your committee approves the retention of the exchange and reorganization provisions with these changes. *Reorganizations are now being consummated in the majority of cases* to reduce the capital structure, and *to strengthen the financial condition of the participating corporations. If the reorganization provisions were omitted from the bill, many* stockholders and *bondholders could take large losses*, although they might retain substantially their former interests in the enterprise. Hence, the Treasury

has little or nothing to gain by the elimination of these provisions, while, on the other hand, some legitimate and desirable business readjustments would be prevented." (Italics supplied.)

The Conference Committee Report said (C. B. 1939-1, Part 2, page 632):

"Amendments Nos. 49, 50, 51, and 52: *These amendments broaden the scope of a reorganization* (as defined in the House bill) in connection with which exchanges of property may be made without the recognition of gain or loss. The amendments, in addition to making it clear that mergers and consolidations, as those terms are used in the reorganization definition, are confined to statutory mergers and consolidations, add to the definition of reorganizations the acquisition by one corporation for all or part of its voting stock of (1) 80 per cent of the voting stock and at least 80 per cent of the total number of shares of all other classes of stock of another corporation, *or* (2) *substantially all the properties of another corporation.* To conform to this addition, the definition of 'a party to a reorganization' is extended to include both corporations in the type of cases just mentioned. The House recedes." (Italics supplied ours.)

In response to the recommendation of a subcommittee of the Ways and Means Committee that the reorganization provisions be eliminated the Acting Secretary of the Treasury submitted a statement reading in part as fol-

lows: (Report of subcommittee of Ways and Means Committee, 73rd Cong. 2nd Sess., p. 9)

"In the second place, reorganizations today are generally being carried out in order to revise the capital structures of unsuccessful or insolvent enterprises. The immediate result of abolishing the reorganization provisions would be to permit the thousands of bondholders and stockholders of such organizations to establish losses, even though they obtain and retain securities in a new enterprise which is substantially the same as their original investment. Even though it be required that such losses can only be deducted from capital gains, a wide door will be opened to reduction of tax liability."

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

No. 503

PALM SPRINGS HOLDING CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF OF PETITIONER

JOHN E. HUGHES,
First National Bank Building, Chicago,

THOMAS R. DEMPSEY,
1104 Pacific Mutual Building,
Los Angeles,
Attorneys for Petitioner.

FRANK MERGENTHALER,
548 South Spring Street, Los Angeles,
Of Counsel for Petitioner.

U. S. Law Printing Co., Phone Lakeview 6581, Chicago, Illinois

INDEX

	PAGE
Importance of the Question at Bar	2
Some Aspects of a Broad View of the Question	3
So Far as the Government's Argument is Pitched on Le Tulle v. Scofield, 308 U. S. 415, It Is Unsound	7
Summary of Technical Argument	10
There Was Unquestionably a Reorganization Here Within the Literal Language of the Statute	13
The Application of Clause (B) of the Definition to the Case at Bar	18
The Application of Clauses (C) and (D) to the Case at Bar	19
The Continuity of Interest Theory and Its Application Here	20
The Crucial Statute	23
The Bondholders of the Insolvent Corporation Had at Least a 50% Control Over Its Property and It Remained in Them After the Transfer	25
Bondholders of a Solvent Corporation Have No Proprietary Interest in Its Property	26
Insolvency Completely Changes the Situation and Gives the Bondholders a Proprietary Interest	27
For Sixteen Years the Administrative Practice, Approved by the Courts, Uniformly Treated Bondholders' Reorganizations as Reorganizations	29

Separate Tax Consequences Are Not to Be Attached to a Reorganization Sale 31

Basis If No Reorganization 33

Conclusion 35

APPENDICES

Appendix A—Speech of Hon. George A. Paddock of Illinois in the House of Representatives Monday, August 25, 1941 ..... a-c

Appendix B—Analysis of Decision Below ..... b-e

Appendix C—Page to Page Answer to Government Brief in No. 286 Therein (Southwest Consolidated Case) ..... f-i

CITATIONS

CASES:

Browder v. United States, 312 U. S. 335 13

Case v. Los Angeles Lumber Co., 308 U. S. 106 12

Commissioner v. Newberry Lumber Co., 94 F. (2d) 447 30

Consolidated Rock Products Co. v. Du Bois, 312 U. S. 510 12

Cortland Specialty Co. v. Commissioner, 60 F. (2d) 937 29

Crooks v. Harrelson, 282 U. S. 60 18

G. & K. Manufacturing Co. v. Helvering, 296 U. S. 389 11

Graham v. LaCross Ry. Co., 102 U. S. 148 27

Hale v. Helvering, 85 F. (2d) 8 33

Helvering v. Bashford, 302 U. S. 454 31

Helvering v. Minnesota Tea Co., 296 U. S. 378 ..... 11, 14, 16, 20

Helvering v. Winmill, 305 U. S. 79 15
Higgins v. Smith, 308 U. S. 473 33
Hollins v. Brierfield Coal Co., 150 U. S. 371 27
Huber v. Martin, 127 Wis. 412 19
Le Tulle v. Scofield, 308 U. S. 415 ..... 7, 21, 26
Louisville Tr. Co. v. Louisville R. Co., 174 U. S. 674 32
Monarch Electric Wire Co. v. Commissioner, 38 F. (2d) 417 26
Nelson Co. v. Helvering, 296 U. S. 374 22
Northern Pacific R. Co. v. Boyd, 228 U. S. 482 27
Pinellas Ice Co., 287 U. S. 462 15
Price v. United States, 269 U. S. 492 27
Shipowners Tugboat Co., 4 B.T.A. 403 36
United States v. Hendler, 303 U. S. 564 4
Union Petroleum Co. v. Edwards, 7 F. (2d) 301 7

STATUTES:

Sec. 112 (i) (1), Revenue Act of 1932 ..... 13, 14
Sec. 113 (a) (7), Revenue Act of 1932 23
U. S. C. Title 11, Sec. 795 ..... Appendix i

MISCELLANEOUS:

House Hearings on Revenue Act of 1941, pages 479 to 486 3
55 Harvard Law Review, 298 8
51 Yale Law Journal, 128 ..... 9, 36
Vol. 1, 1940 C.C.H. Tax Service, at page 63 9
G.C.M. 7472; C.B. XI—1 p. 184 24
I.T. 2071, C.B. III—2 at page 34 29
Mim. 4555, C.B. 1937—1 p. 244 21

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May It Please the Court:

The undersigned has just been retained to argue this case and files this brief to ask the court to consider the following points.

Importance of the Question at Bar

Perhaps no tax case will come before this court at the present term presenting a more important question than these related cases now at bar.

The basis of corporate property for depreciation, for invested capital and for computing profit on sale for thousands of corporations is here involved and not only that but the related basis of tens of thousands of security holders who exchanged their securities in the thousands of depression reorganizations. (See note on Judicial Notice of Scope and Effect of the Depression, 81 L. ed. 1103.)

Illuminating one important phase of the question to be decided is the circular entitled "Federal Tax Problems of Railroads In Reorganization," dated August 27, 1941, issued by the Association of American Railroads and by the Railroad Security Owners Association. It states 75,000 miles of railroad are now in process of reorganization, including fifteen major carriers. Many of the other large roads have passed through reorganization. It states the Interstate Commerce Commission prescribed regulations in the *Chicago Great Western* case, *Ex Parte* 138, which require reorganized carriers to show on their books the original cost to the old corporation as the "basis of property"; that the Bureau of Internal Revenue is now contending otherwise and that its contention ought to be eliminated by legislation because it defeats the sound purposes of reorganization, jeopardizes the future credit of the railroads upon which depends maintenance of the property in the public welfare and may prevent the consummation of pending reorganization plans because of the reluctance of security holders to accept drastic reductions in their securities.

Thousands of hotels, apartment houses and industrial corporations went through depression reorganizations and all have the same question.

Insurance companies, like other bondholders, are vitally effected and attention is called to the testimony before the Ways & Means Committee on behalf of the Superintendent of Insurance of the State of Ohio. (See House Hearings on Revenue Act of 1941, pages 479 to 486.)

On a question of such great and far-reaching importance it is submitted the uniform administrative practice, undisturbed for over fifteen years and continued, over the protest of taxpayers, with the acquiescence of Congress, the sanction of the Tax Board and the Courts, ought not at this late date be reversed by this court when its reversal will do irremediable harm and if it is to be changed at all the change should be by legislation which makes provision for allowing to bondholders a deduction for the losses they were denied by the treasury ruling.

Some Aspects of a Broad View of the Question

With present tax rates on individual incomes (starting at 51% on the first dollar over $26,000 and gradually increasing) and on corporation incomes (normal tax 24 per cent; surtax 7 per cent; excess profits tax up to 60 per cent and declared value excess profits tax from 6 per cent to 13.2 per cent) as high as they now are (and they are to be further increased this year) all will concede decisions on important tax questions cannot be made with as little consideration as when the rates were nominal because, due to the high rates, they are so vitally interwoven with the national economic life which in its turn goes to the core of the national existence and the efficient prosecution of the war.

No group of men could hear a complicated technical question of broad national effect argued on Monday and always decide wisely on Saturday (with a variety of other matters to be heard and decided in between) unless a view of the effect of the principle laid down from all angles should be lucidly placed before them by counsel and the result of days and weeks of study and exhaustive consideration of the question by an expert administrative tribunal should be thoroughly digested in the meantime.*

With the thousands of tax cases in its files it is easy for the government to select an extreme and factually favorable case to test any question and such is increasingly becoming its practise.

It apparently has selected in the *Southwest Consolidated* case its most favorable case and it stresses on page 13 of its brief therein (No. 286 this term) that the bondholders for an investment of approximately $1,750,000 will have the benefit of a corporate investment of about $9,000,000 if the Court of Appeals is affirmed.

---

*The decision of this court in **United States v. Hendler**, 303 U. S. 564, would have virtually erased the reorganization provisions from the books had it not been promptly repealed by legislation. (See "Studies in Federal Taxation, Third Series" Paul p. 39 and pages 134 to 145.)

The Committees of Congress in recommending the repeal of this decision states as follows:

> "The recent Supreme Court case of **United States v. Hendler** (303 U. S. 564 (1938)) has been broadly interpreted to require that, if a taxpayer's liabilities are assumed by another party in what is otherwise a tax-free reorganization, gain is recognized to the extent of the assumption. In typical transactions changing the form or entity of a business, it is not customary to liquidate the liabilities of the business and such liabilities are most invariably assumed by the corporation which continues the business. Your committee therefor believes that such broad interpretation as is indicated above **will largely nullify the provisions of existing law** which postpone the recognition of gain in such cases. To enable bona fide transactions of this type to be carried on without the recognition of gain, the committee has recommended section 213 of the bill."

(For this report see C. B. 1939-2 p. 518.)

Some other decisions reversed by Congress are **United States v. Michel**, 282 U. S. 656 by sec. 3722(2) of the Code and **United States v. Swift & Co.**, 282 U. S. 468 by sec. 3770(3).

Obviously if the government's contention is upheld in this case the result will be that so far as the depression reorganizations are concerned the Statute will be a nullity.

Superficially considered this seems a very potent argument but thorough analysis of it discloses the havoc its necessary ramifications will cause should it be adopted. It will also reveal that injustice will be done and the government will get a bigger tax windfall if it is adopted than taxpayers will get if it is rejected.

In the first place if the government argument is rejected and if taxpayer's argument is adopted, bondholders who went through depression reorganizations unquestionably must pay income taxes at the constantly increasing rates on every cent they receive in excess of what the bonds cost them, and thus obviously do not receive a tax windfall whereas if the government's argument is adopted these bondholders on thousands of cases must pay income tax at extremely high rates on a large part of the money they invested in their bonds and also the base to the corporation on the property bought with the money procured from the bondholders will be less than its cost.

A lucid illustration of the way the rule contended for by the government in these cases will work is contained in the speech in the Congressional Record of August 25th (Vol. 87, p. a4343) which is reprinted in the appendix to this brief at pages a to c. (Why didn't the government bring up a case like that instead of the *Southwest* case?)

At the bottom of page 13 of its brief in the *Southwest* case (No. 286 herein) the government states:

> "In contrast, the government's position reaches a result that is sound and fair. A new cost basis is adopted for the taxpayer measured by what the creditors pay when they became the owners."

If bondholders have paid $15,000,000 for their bonds and the corporate property had shrunk in the great de-

pression to $4,000,000 and they were denied any loss on what was then considered a reorganization, how is it either sound or fair to adopt a base of $4,000,000? If they only get their investment back they will be taxed on a profit of $6,000,000. Is this fair?

This speech is quoted in the appendix that the court may be fully aware of the consequences that will flow from the adoption of the rule for which the government contends. Under the rule for which the government contends, taxpayers investing fifteen million in bonds might be taxed on a profit of six million although they only get back $10,000,000 of their original investment and actually lose $5,000,000. Also if a corporation bought property for $15,000,000 if the bondholders' money and never deducted any loss it must pay income tax on a large part of the cost of this property when it sells it, *i.e.*, all it gets for the property over its depression value.

In other words, those who sustained losses at the time of reorganization, which they could not deduct because of the treasury holding that a reorganization existed, must pay tax at present high rates on such portion of the losses as they may recover.

The important thing ever to be in mind in tax cases and apparently wholly overlooked by the government in the *Kitselman* case, is that a rule does not merely decide the case at hand but cuts both ways and sometimes with a sharp double edge.

In the *Southwest* case the old corporation actually invested about $9,000,000 in the property acquired by the new one and that old corporation has never been allowed any loss on that investment. This investment is earning the income upon which taxes are being paid.

The theory on which our tax law is drafted entirely divorces the stockholder or the security holder and the corporation and prescribes a separate base for each. It will not do to confuse the two. Examples of how the Statute applicable here cuts both ways are the many cases in which stockholders paid for their stock many times what the corporation invested in its property and contended it should have the cost of their investment as its base. Such contention has been uniformly repudiated both by departmental ruling and Judicial decisions. *Union Petroleum Co.* v. *Edwards*, 7 F. (2d) 301, published as T. D. 3699. *Shipowners Tugboat Co.*, 4 B. T. A. 403. *Monarch Electric & Wire Co.* v. *Commissioner*, 38 F. (2d) 417 (C.C.A. 7th). *Cf. LaBelle Iron Works* v. *United States*, 256 U. S. 377.

The fallacy of the argument that the basis of its property to the corporation should not exceed what the stockholders pay for their stock and of the attempt to connect the two is illustrated by the fact that at this writing U. S. Steel is quoted on the stock exchange at $51 per share whereas the basis to the corporation of its property is over $130 per share.

So Far as the Government's Argument Is Pitched on Le Tulle v. Scofield, 308 U. S. 415, It Is Unsound.

The government's argument, pitched on *LeTulle* v. *Scofield*, 308 U. S. 415, has received long and careful consideration and has been rejected by the following:

(1) The expert and able personnel of the United States Board of Tax Appeals. See 42 B.T.A. at p. 483 and its opinions in all the cases at bar. ("An informed and expert tribunal renders its decisions with an eye that looks forward to results rather than backwards to precedent." President Roosevelt's message vetoing Walter-Logan bill.)

(2) Three Circuit Courts of Appeal composed of able and experienced Judges whom everyone will concede to be among the ablest Jurists in this country. See opinion of Judge Learned Hand in *Helvering* v. *New Haven & Shore Line Ry. Co.*, 121 F. (2d) 985 (C.C.A. 2nd); opinion of Judge Orrie L. Phillips in *Commissioner* v. *Cement Investors*, 122 F. (2d) 380 (C.C.A. 9th); opinion of Judge Sibley in *Commissioner* v. *Alabama Asphaltic Co.*, 119 F. (2d) 819 (C.C.A. 5th). Two of these courts had before them the decision in the case at bar and carefully considered and refused to follow it, pointing out wherein it was in error. Prior to the decision in the case at bar the government itself had successfully maintained the position for which we contend in *Commissioner* v. *Kitselman*, 89 F. (2d) 458 (C.C.A. 7th). Note the very able defense of that decision, signed by Justice Reed, quoted at page 15 of taxpayer's brief in *Alabama Asphaltic Company* case, No. 328 herein, which induced this court to deny certiorari in 302 U. S. 709. The sixth Circuit Court of Appeals independently reached the same conclusion in *Commissioner* v. *Newberry Lumber Co.*, 94 F. (2d) 447.

Again that impressive weight of authority the decisions of the learned court below stands alone. Its *ratio decidendi* is analyzed in Appendix B at pages d to e hereof.

(3) Impartial text writers and Law Reviews with unanimity condemn the theory of the court below. No writer can be found who approves it. See Paul, quoted on page 18 of taxpayer's main brief herein. See Note in 55 Harvard Law Review 298, which

considers all the cases at bar and supports the theory for which taxpayer contends. See note on *Le Tulle* case in 49 Yale Law Journal 1079, which calls attention to the single transaction rule (an answer to the government's attempt to isolate the foreclosure sale) and concludes the continuity of interest test is properly applicable only to the consideration received from the transferee at the completion of the transaction "and the nature of the original investment should be irrelevant in determining the character of the transaction which purports to be a reorganization." See also other articles cited on page 18 of our main brief and 51 Yale Law Journal 128.

In an extensive analysis, covering 18 pages, published in Vol. 1, 1940 C.C.H. Tax Service, at page 63, under Illustrative Cases, the editor reviews all the cases at bar and discusses the dissenting opinions of some of the Board members, points out certain provisions of the Statute which they overlook and conclude that there is no ground for saying the *Le Tulle* case overrules the *Kitselman* case.

A decision which reached the same result as that reached by this court in the *Le Tulle* case was *Worcester Salt Co.*, 75 F. (2d) 251, on substantially the same state of facts. The taxpayer's petition for certiorari in the *Kitselman* case alleged conflict with this decision but on page 14 of its brief in opposition the government correctly distinguished the case by saying: "None of these cases present the situation of a corporation so absolutely insolvent that the old stockholders could have no interest in the reorganization."

Summary of Technical Argument

Taxpayer acquired its property in August, 1932. It contends section 113 (a) (7) of the Revenue Act of 1932 (quoted on page 23 hereof) fixes the basis of depreciation. Whether it does is the issue in this case. The government contends it does not because it says the property was not acquired "in connection with a reorganization." Manifestly, the bondholders controlled this property prior to its transfer to taxpayer and instead of reorganizing and transferring it to the taxpayer they could have sold it to a stranger if they had so elected. After its transfer to taxpayer a 50 per cent control in the property remained in them since they owned more than that amount of taxpayer's stock. See 51 Yale Law Journal 128.

The government's argument that the property was not acquired by taxpayer "in connection with a reorganization" is pitched solely on the contention that conceding this case is literally within the statutory definition of a reorganization, contained in Clause (A) quoted on page 13 hereof, there can be no reorganization without a continuance of shareholder interest (a qualification it says has been read into the Statute by the courts). (The courts have used the word "proprietary" interest not "shareholder" interest).

Assuming, but not conceding, that a stockholder interest must continue, it is of no avail here because there was here a continuity of stockholder interest. It was stipulated and found as a fact by the Board of Tax Appeals that for over eleven months prior to the acquisition of the property by petitioner Warren B. Pinney was the sole stockholder of the prior company owning the hotel (R. 24, 25). He received 1000 common shares of petitioner

out of 7500 or about 13 per cent thereof. (Petitioner also had outstanding 1752 preferred shares.)

In *Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378 (see analysis in C.B. 1937-1 p. 246) 7½ per cent of the transferee's stock was held substantial. In *Helvering* v. *Watts*, 296 U. S. 387, less than 10 per cent was held substantial.

In *G. & K. Manufacturing Co.* v. *Helvering*, 296 U. S. 389, the stock received was less than 1½ per cent of the outstanding stock of the transferee. In *Schuh Trading Co.* v. *Commissioner*, 95 F. (2d) 404, 407, it was even less than 7½ per cent. In *Miller* v. *Commissioner*, 84 F. (2d) 415, 417 (C.C.A. 6th), a substantial continuity of interest is defined as something more than nominal. Under the existing reorganization statute a transfer of property to a corporation for the sole consideration of its voting stock is a reorganization regardless of how small a portion of the transferee's stock it is. (See page 22 hereof.)

It is submitted that neither the words of the statute, authority or reason support the suggestion in note 13 on page 23 of the government brief in the *Southwest Consolidated* case that the stockholder of the old corporation must receive his stock in the new one as a stockholder of the old and for his stock in the old. To so hold would be to superimpose a qualification not in the statute upon a second qualification not in it and an absurd one at that. Suppose you own all the stock and bonds of a corporation which becomes insolvent and you reorganize it and take all the stock of the new company for your bonds. Can it be said you do not retain your proprietary interest in its property or that it does not continue merely because you have not received your stock qua stockholder of the

old company? If the test requires a continuance of proprietary interest it is enough if it does continue and is immaterial how it continues. In this example you have always a 100 per cent proprietary interest in the property.

The substantial continuity of stockholder interest distinguishes the case at bar from most of the others and alone warrants the result reached by the Board of Tax Appeals.

Also, every case, except the two decisions of the court below now at bar, denying a reorganization because of lack of continuity of proprietary interest deals with sales to outside interests and not with internal readjustments among security holders where no new parties come in, albeit the Statute, quoted on page 23 hereof, allows a 50 per cent new interest to come in.

Apart from the above this case is also within Sec. 113 (a) (7) because (1) it falls literally within the language of the Statute defining a reorganization, particularly clauses (a) and (e) thereof, and (2) when the old corporation became insolvent its assets became a trust fund for the bondholders and they alone had a 100 per cent interest therein. *Case* v. *Los Angeles Lumber Co.*, 308 U. S. 106. *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510, 529. A beneficiary of a trust fund has an interest in the trust property. *Blair* v. *Commissioner*, 300 U. S. 5, 13. This interest remained in them after the transfer to the new company. (55 Harvard Law Review, 294; 51 Yale Law Journal 137.) Also the bondholders then had a 100 per cent control over the property and the stockholders had no right to speak. This control remained in them after the transfer.

Express statements in reports of Congressional Committees show Congress considered bondholders might sub-

stitute stock for bonds and be unable to deduct a loss because a reorganization would exist. (See report quoted on page 32 of our main brief; also page 36.) Acceptance of the government contention means it was impossible to reorganize under the Revenue Act a corporation made insolvent by the depression.

There Was Unquestionably a Reorganization Here Within the Literal Language of the Statute.

That there was a reorganization here within the terse, plain, blunt language of the statutory definition of reorganization is conceded (page 9 of government brief herein).

As repeated in *Browder* v. *United States*, 312 U. S. 335, 338: "No single argument has more weight" than that a case falls within the plain words of the Statute.

Petitioner acquired its property in 1932 and the definition of reorganization in that act governs. See Statute (Sec. 113 (a) (12) quoted on page 28 of our main brief. See also *Schwitzer & Conrad, Inc.*, 41 B.T.A. 533, 539, 540.

The applicable statutory definition of reorganization is as follows (Sec. 112 (i) (1) quoted on page 30 of our main brief):

> "(1) The term reorganization means * * * (A) a merger or consolidation (including the acquisition by one corporation of * * * substantially all the properties of another corporation)."

The definition also contains clause (B) which is applicable only if the bondholders are considered the same as stockholders. (A point which need not be considered under clause (A) above quoted.) This definition in clause (B) reads: "A transfer by a corporation of all or part of its assets to another corporation if immediately

after the transfer the transferor or its stockholders or both are in contol of the coporation to which the assets are transferred." *Commissioner* v. *Cement Investors*, 122 F. (2d) 380, 384, holds bondlfolders of an insolvent corporation are in the position of stockholders.

The definition also contains the catch-all phrase reading as follows:

> "or (C) a recapitalization or (D) a mere change in identity, form or place of organization, however affected." (Inadvertently omitted on p. 14 of government brief).

For the reasons stated on page 19 hereof, taxpayer submits its case also falls within above quoted clause (D) defining a reorganization as "a mere change in place of organization, however effected."

To fall within any one of the above definitions is enough for "these clauses have separate legislative histories and were intended to be mutually exclusive." *Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378, 384.

While a number of lower court decisions have stated the reorganization provisions confer an exemption from tax this is not so. As the Committees of Congress first reporting the provisions in 1924 stated:

> "The provisions of sec. 203 of the bill that no gain or loss is recognized from certain exchanges do not grant an exemption and are not so intended. * * * In other words the provisions result not in an exemption from tax but in a postponement of tax until the gain is realized by a pure sale or by such an exchange as amounts to a pure sale." (H.R. No. 179, 68 Cong. 1st Sess. p. 19 and Sen. Rep. 398, 68th Cong. 1st Sess. pp. 14, 16, 17.)

Obviously, in an era like the present, in which tax rates are increasing year by year it is to the advantage of the revenue to postpone tax to a year of higher rates. On the contrary the year involved in the *Pinellas Ice Co.* case, 287 U. S. 462 (1926) was an era of treasury surplus and annually decreasing tax rates. In that case $400,000 cash was paid the seller on December 15, 1926 and the balance of $1,000,000 was payable in cash, $500,000 in forty-five days and $250,000 each in sixty and ninety days thereafter. (*Cf.* Sec. 44 of the Code which provides that on a casual sale of personal property where the initial payment does not exceed 30 per cent, the income may be returned when the notes are paid.)

Incidentally, for a taxpayer who in 1940 sold property for $50,000 cash and $750,000 bonds payable in 1943, to be taxed on all the profit in 1940 as the *Le Tulle* case holds, rather than when the bonds are paid would be a great benefit to him, not only because of lower normal tax rates in 1940 but because the capital gains tax, which is limited to 15 per cent of the profit, may be repealed in 1942 and all gains taxed at the ordinary rates.

The regulations under the 1932 Act (Art. 577, Reg. 77) and since 1924 stated the acquisition by one corporation of substantially all the properties of another was a reorganization. As the court points out in 76 F. (2d) 797 at p. 800 these regulations, and decisions there cited construing them, were approved by Congress which many times reenacted this language without change while these regulations were in force. *Cf. Helvering* v. *Winmill*, 305 U. S. 79, 83.

The above quoted words of the 1932 Act were radically changed in the 1934 and subsequent acts which require,

under this section of the definition, the property to be acquired solely in exchange for stock. The Committees of Congress in their reports said this changed the law.

In *Pinellas Ice Co.* v. *Commissioner*, 287 U. S. 462, 470, it was said the above quoted words in parenthesis "expand the meaning of the terms merger or consolidation" but do not embrace a sale for cash.

Inasmuch as taxpayer corporation in the case at bar acquired all the property of the other corporation pursuant to a bona fide plan of reorganization and in what I.T. 2071 correctly called "the most common type of reorganization" this case, which concededly falls literally within the statutory definition in Clause (A) ought not to be taken out of it by judicial construction.

Indeed the government concedes the case falls literally within Clause (A) above quoted for here the transfer was not made by an intervening bondholders' committee and the government correctly states on page 9 of its brief: "The transaction thus fits the literal language of Clause A of the Statutory definition of a reorganization."

In the opinion in *Minnesota Tea Co.* v. *Commissioner*, 76 F. (2d) 797, 799 (which this court affirmed) it is said:

> "The particular language of the section relied upon by petitioner as showing that there was a reorganization by the transaction between it and the Grand Union Company is 'the acquisition by one corporation of * * * substantially all the property of another corporation.' The language is plain and unambiguous. The ascertainment of its meaning is simple.
>
> "In *Adams Express Co.* v. *Kentucky*, 238 U. S. 190, page 199, the Supreme Court said: 'It is elementary that the first resort, with a view to ascertaining the meaning of a statute, is to the language used.

If that is plain there is an end to construction, and the statute is to be taken to mean what it says.'

"Such has been the doctrine announced in many cases: *United States* v. *Shreveport Grain & Elev. Co.*, 287 U. S. 77, 83; *Matson Navigation Co.* v. *United States*, 284 U. S. 352, 356; *Wilbur* v. *United States*, 284 U. S. 231, 237; *Corona Coal Co.* v. *United States*, 263 U. S. 537, 540; *United States* v. *Standard Brewery, Inc.*, 251 U. S. 210, 217; *Pirie* v. *Chicago Title & Trust Co.*, 182 U. S. 428, 451; *Price* v. *Forrest*, 173 U. S. 410, 427; *United States* v. *Goldenberg*, 168 U. S. 95, 102.

"The doctrine applies with especial force to tax statutes.

"In *Crooks* v. *Harrelson*, 282 U. S. 55, page 61, the court said: 'Finally, the fact must not be overlooked that we are here concerned with a taxing act, with regard to which the general rule requiring adherence to the letter applies with peculiar strictness. In *United States* v. *Merriam*, 263 U. S. 179, 187, 188, after saying that 'in statutes levying taxes the literal meaning of the words employed is most important for such statutes are not to be extended by implication beyond the clear import of the language used' we quoted with approval the words of Lord Cairns in *Partington* v. *Attorney-General*, L. R. 4 H.L. 100, 122, that 'if the crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible in any statute what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.'

"In *Van Camp & Sons* v. *Am. Can Co.*, 278 U. S. 245, page 253, the court used the following language: 'The words being clear, they are decisive. There is nothing to construe. To search elsewhere for a mean-

ing either beyond or short of that which they disclose is to invite danger, in the one case, of converting what was meant to be open and precise, into a concealed trap for the unsuspecting, or, in the other, of relieving from the grasp of the statute some whom the Legislature definitely meant to include.' "

Congress, at the time it enacted the foregoing definition in 1932, certainly knew that reorganizations such as this one were taking place by thousands and that they fell squarely within the literal words of the law and if it had intended to exclude them from the plain terms of the Statute certainly could and would have done so. On the contrary, the Committee reports, quoted at pages 31 to 36 of our main brief, confirm that it intended to include them. As pointed out in *Crooks* v. *Harrelson*, 282 U. S. at p. 60, while this court has the power it has no constitutional right to exercise legislative power and must restrain itself from so doing.

The Application of Clause (B) of the Definition to the Case at Bar.

Since it is conceded that the situation at bar is literally within clause (A) that should be enough.

However, it should be pointed out *Commissioner* v. *Cement Investors*, 122 F. (2d) 380, 384, also holds clause (B) applicable on the ground that the bondholders were stepped down to the position of stockholders by the insolvency and were in control of the corporation to which the assets were transferred.

What is the meaning of the word "stockholders"? Certainly, one may be a stockholder who only holds non-voting stock entitling him to share only in the assets on dissolution. There is a wide variety of stock, including debenture

stock, and it has been held that a policyholder in a mutual insurance company is a stockholder within the meaning of that word in its charter. (*Huber* v. *Martin*, 105 N. W. 1031, 1038, 127 Wis. 412.) Here the right to say what would be done with the assets passed to the bondholders who could have sold them to strangers or recapitalized the old corporation, substituted stock for their bonds and eliminated its sole remaining stockholder instead of reorganizing and issuing 1000 shares of the new corporation to him.

In its brief in the *Kitselman* case, quoted on page 20 of our main brief herein, the government stated:

> "Under these decisions, it is submitted that for reorganization purposes, a bondholder stands in no different position from a stockholder with respect to an interest in the assets and affairs of a corporation."

Answering the argument in note 3 on page 9 of the government's brief a reading of clause (B) shows it only requires the stockholders of the old corporation to receive 80 per cent of the stock of the new one. If they get it the statute is satisfied. It does not require them to get it for their stock or their bonds.

The Application of Clauses (C) and (D) to the Case at Bar

These clauses (quoted on page 14 hereof) were thrown in by Congress as catch-all clauses.

Under (D) a change in place of organization "however effected" is a reorganization.

That happened here. The transferor corporation was organized in Nevada (R. 23). The petitioner was organized in California (R. 22).

Before petitioner was organized all the stock of the old company except Mr. Pinney's had been bought by it and Mr.

Pinney with his ten shares was its sole stockholder since September 2, 1931. (Finding and stipulation R. 24). From that date to April 1, 1932 when petitioner was organized (R. 25) the sole interest in the old corporation's property was unquestionably in its bondholders and its sole stockholder Mr. Pinney. They kept that identical interest when they merely changed the state of organization. Hence Clause (D) applies.

The Continuity of Interest Theory and Its Application Here.

The requirement of some continuity of proprietary interest in property transferred did not appear in the Statute, which was in the same form from 1924 to 1934 when it was changed as hereinafter detailed.

In its brief in the *Kitselman* case, quoted on page 20 of taxpayer's main brief, the government stated:

> "Where, as in the present case, the bondholders were the only parties in interest in the assets of an insolvent corporation, a continuity of their interest in the assets in the bonds of a new corporation is a sufficient compliance with the Statute."

The continuity of interest theory first appeared in *Cortland Specialty Co.* v. *Commissioner*, 60 F. (2d) 937 (C.C.A. 2nd) decided in 1932. Eight years had elapsed before anyone thought it a requirement of the statute. It was evolved by the court to prevent profit on a pure sale to outside interests escaping tax and has never been invoked or applied for any other purpose.*

In *Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378 (decided in 1935) this court stated at p. 384 that in the *Pinellas Ice Co.* case it "approved the conclusion of the Commis-

*In Newstadt, 43 B.T.A. 848, the Board refers to "a taxable sale lurking in disguise".

sioner, Board of Tax Appeals and Court of Appeals that the transaction there involved was in reality a sale for the equivalent of money." This court at p. 385 repeated its statement in the Pinellas case that to be a reorganization "the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to the ownership of its short term purchase money notes." This court then stated: "And we now add that the interest must be definite and material; it must represent a substantial part of the value of the thing transferred."

The rule of these cases has been reiterated. *Groman* v. *Commissioner*, 302 U. S. 82, 89; *Helvering* v. *Bashford*, 302 U. S. 454, 456. See Mim. 4555, C.B. 1937—1 p. 244.

In *Le Tulle* v. *Scofield*, 308 U. S. 415, the rule was stated as follows, at page 420:

> "We have said that the statute was not satisfied unless the transferor retained a substantial stake in the enterprise and such stake was thought to be retained where a large proportion of the consideration was in common stock of the transferee."

At page 421 the decision in the *Le Tulle* case was stated by this court as follows:

> "Where the consideration is wholly in the transferee's bonds or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise."

That is not the situation in the case at bar. Here unquestionably a proprietary interest was retained by the old company's sole stockholder and by its bondholders.

It was not until 1934 that Congress wrote the requirement of continuity of interest into clause A of the Statute

by requiring that the consideration for the assets be solely voting stock. (A circumstance in support of the statement quoted from the Yale Law Journal on page 9 hereof, that the test of continuity of interest only applies to the consideration received at the conclusion of the transaction.)

The Committee reports expressly stated this 1934 provision was a change in existing law. (See page 34 of our main brief for report and note reference to "these changes".)

> "It is not our function to engraft on the language of the statute additions which we think the legislature logically might or should have made" 312 U. S. at page 605.

A bare reading of the Statutory definition of reorganization discloses loss of control by the stockholders of the transferor does not prevent the transaction being a reorganization within many of its clauses and this court has so stated. *Nelson Co.* v. *Helvering*, 296 U. S. 374, 377, *Fisher* v. *Commissioner*, 108 F. (2d) 707 cer. den. 310 U. S. 627. Under the Statute, as it now reads, the owner of the corner grocery could transfer it to the Great Atlantic & Pacific Tea Co. for 300 shares of its voting stock and it would meet the statutory definition of reorganization (See sec. 112 (g) (1) (c) of the Code). This the department's regulations concede.

The cases cited on page 11 hereof, holding reorganizations existed, show some percentages of the transferee's stock which this and other courts have held satisfied the requirement of continuity of interest. Under those cases that requirement is alone met in the case at bar by the issuance of 1000 shares of common stock to the sole stockholder of the old company (See page 11 hereof) disregarding the balance issued to its bondholders.

Moreover while it has been held that the interest which should be continued must be a proprietary interest in the property transferred, no holding has gone beyond that. No case has held that there can exist no proprietary interest in property transferred prior to its transfer except a shareholder interest. Indeed, a reading of the statute quoted on below will disclose an individual could transfer property to a corporation controlled by him and be within it. In other words, if he transferred one of his individually owned plants to a corporation, in which he owned 95 per cent of the stock, in connection with a reorganization, it would take the same basis under Sec. 113 (a)-(7) as it had in his individual ownership, albeit there was no continuity of shareholder interest in such property. A continuity of proprietary interest would be enough.

Also all the cases in which this court held a reorganization did not exist were sales to outside interests. None of them were internal adjustments like the case at bar.

The Crucial Statute

The statute directly involved is Section 113 (a) (7) of the Internal Revenue Code which reads as follows:

> "113 Adjusted basis for determining gain or loss.
>
> "(a) Basis (Unadjusted) of Property. The basis of property shall be the cost of such property; except that—
>
> "(7) Transfers to corporation where control of property remains in same persons. If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of

loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.'"*

Under its words "an interest or control of 50 per centum or more" must remain in "the same persons or any of them" • • • "immediately after the transfer".

In the first place either a 50 per cent "interest or control" in the property is enough. Both interest and control are not required.

What is meant by the word "interest"? The Bureau of Internal Revenue in G.C.M. 7472; C.B. XI-1 p. 184 at p. 191 construes it as follows:

"The term 'interest' is a very broad one, clearly much broader than the term 'ownership' and since it is used in a provision having reference only to property owned by a corporation and acquired in connection with a reorganization (commonly, if not universally, in connection with a transfer by one corporation to another) the conclusion is irresistible that the term in section 204 (a) (7) is used to designate that ultimate or beneficial species of rights, in the nature of ownership which the individual shareholder has in property the direct ownership of and the beneficial and legal title to which is in a corporation of which the individual is a shareholder. Any other construction would render the statute totally meaningless, for if the statute contemplates ownership, either legal or equitable, it is obvious that the acquiring corporation has the whole

*Sec. 113 (a) (7) of the Internal Revenue Code, as now existing, expressly eliminates the necessity of retention of a 50% interest where the transfer was made after December 31, 1935. In such case if there was a reorganization the basis is the same.

legal and equitable ownership, and accordingly no interest or control of any percentage can be said to remain in anyone 'immediately after the transfer.' "

With unanswerable logic the above ruling points out that the interest in the property to which the Statute refers is not the legal title (as the government seems to contend here) but the ultimate beneficial interest in the property. In *Consolidated Rock Products Co.* v. *Du Bois*, 312 U. S. at page 529, note 27, this court states the old stockholders "admittedly had no equity in the enterprise." Since the stockholders had no equity necessarily the bondholders had it all and they retained this interest and the Statute was complied with when they received over 50 per cent of the stock of the transferee.

The Bondholders of the Insolvent Corporation Had at Least a 50% Control Over Its Property and It Remained in Them After the Transfer.

Sec. 113 (a) (7) quoted on page 23 hereof does not require the 50 per cent interest or control to remain in the transferor corporation after the transfer. This will be conceded. (See department's ruling quoted on page 24 hereof.)

Because of the insolvency of the transferor corporation control of its property passed from its stockholders to its bondholders.

As correctly stated in the government's brief in this court in the *Kitselman* case (quoted at page 15 of taxpayer's brief in No. 328 herein), "The only reason the stockholders did not participate in the plan was that their stock represented no assets and was valueless, and therefore they were without right to speak. See *In re* 620 Church St. Corp., 299 U. S. 24, 27."

The bondholders alone controlled the property months prior to the transfer and had a right to do what they pleased with it and after the transfer the bondholders owned all the stock of the transferee except 1000 shares issued to the sole stockholder of the transferor. Hence a 50 per cent "control" in the property remained "in the same persons or any of them" after the transfer. For construction of the words "or any of them" see *Monarch Electric Wire Co.* v. *Commissioner*, 38 F. (2d) 417 (C.C.A. 7th). *Fairbanks Court Co.* v. *Commissioner*, 84 F. (2d) 17; cer. den. 299 U. S. 582.

This control passed to the bondholders contemporaneously with the insolvency of the transferor. After it has passed to them they formulated the plan of reorganization and the reorganization began. Instead of deciding to reorganize and transfer it to taxpayer they might have sold the property to a stranger for cash.

If the bondholders had a 50 per cent control of the property transferred before the transfer it need not be asked whether the bondholders had a 50 per cent interest therein. Of course, the bondholders had such a control of the property unless the court is to be completely blind to substance and reality, which it has many times declared control in tax cases.

Bondholders of a Solvent Corporation Have No Proprietary Interest in Its Property

In deciding in *Le Tulle* v. *Scofield*, 308 U. S. 415, that the bondholders of a solvent corporation have no proprietary interest in its property while it remains solvent, this court merely repeated what it had said many times and over many years.

Thus in *Hollins* v. *Brierfield Coal Co.*, 150 U. S. 371, 383:

> "Solvent it holds its property as an individual holds his, free from the touch of a creditor who has acquired no lien * * *"

Insolvency Completely Changes the Situation and Gives the Bondholders a Proprietary Interest

In the same case the court said at p. 385:

> "Becoming insolvent * * * places the property in a condition of trust first for the creditors and then for the stockholders."

In *Graham* v. *LaCross Ry. Co.*, 102 U. S. 148, 161:

> "When a corporation becomes insolvent, it is so far civilly dead that its property may be administered as a trust fund for the benefit of its stockholders and creditors. A court of equity at the instance of proper parties will then make these trust funds, which in other circumstances are as much the absolute property of the corporation as any man's property is his."

This statement is repeated in *Mellen* v. *Moline Iron Works*, 131 U. S. 352; *Blake* v. *McClung*, 172 U. S. 239, 254. In the leading case of *Northern Pacific R. Co.* v. *Boyd.*, 228 U. S. 482, at p. 504, it is said:

> "The property was a trust fund charged primarily with the payment of corporate liabilities."

In *Investment Register Ltd.* v. *Chicago M. E. Ry. Co.*, 212 Fed. 594 (C.C.A. 7th) at p. 609, where the corporation was insolvent:

> "The property virtually belongs in equity to the bondholders."

It is on the trust fund theory that transferee proceedings in tax cases are brought. *Price* v. *United States*, 269 U. S. 492, 502; *Phillips* v. *Commissioner*, 42 F. (2d) 177, 180

(C.C.A. 2nd). The Committees of Congress referred to it as "arising under the trust fund doctrine or some similar theory." (C.B. 1939-1, part 2, p. 354.) *Cf. Commissioner* v. *Keller*, 59 F. (2d) 501.

This interest of creditors as sole beneficiaries of the corporation's property comes into existence as soon as the corporation becomes insolvent and any property subsequently transferred continues to be charged with the trust for them. On the other hand, property transferred by a solvent corporation is free of trust. Creditors have no interest in it.

Finally let us put aside legal technicalities and look at the substance. Most of us who were lucky enough at some time to get more money than we needed for current bills were unlucky enough to have invested some of it in stock of a corporation that became insolvent. To say that we stockholders were the only persons who had an "interest" in the property when the corporation was insolvent and its property was being administered by the receiver for the benefit of the mortgage bondholders and under their charge is to disregard substance and reality. As was said in *Helvering* v. *Lazarus*, 308 U. S. 252, at page 255:

> "In the field of taxation, administrators of the laws and the courts are concerned with substance and realities."

A powerful statement of "practical and common sense recognition to the well defined type of business reorganization" is found in the government's brief in opposition to the petition for Writ of Certiorari, in the *Kitselman* case, which is quoted in the taxpayer's brief of *Alabama Asphaltic Limestone Company*, No. 328, herein, at page 15 thereof.

For Sixteen Years the Administrative Practice, Approved by the Courts, Uniformly Treated Bondholders' Reorganizations as Reorganizations.

In 1924 the Treasury Department ruled in I.T. 2071 published in C.B. III.-2 at page 34 that bondholders' reorganizations in which stockholders were eliminated were "the most common form of reorganization". This ruling is quoted at page 16 of taxpayer's brief in *Alabama Asphaltic Limestone Co.* case (No. 328) and your honor is requested to read it at this point. Also S. M. 2723, C.B. III—1 p. 26. Similar statements appear in court decisions. *Cortland Specialty Co.* v. *Commissioner*, 60 F. (2d) 937, 939; *Securities Co.* v. *Commissioner*, 64 F. (2d) 330, 331; *Cf. DeBlois* v. *Commissioner*, 36 F. (2d) 11, 13 (C.C.A. 1st). All textbooks likewise state it is the most common form of reorganization. Corporations 19 C.J. Sec. 1578, 1585. Fletcher (1938 edition) Vol. 15, p. 367, Sec. 7222.

In 1926 the bureau ruled the same in I.T. 2258 published in C.B. V-I p. 10.

In November, 1930 the Board of Tax Appeals ruled the same in First National Bank of Champlain, 21 B.T.A. 415.

In 1934 the Board ruled the same in Rockford Brick & Tile Co., 31 B.T.A. 537 and at page 540 cited with approval I.T. 2071 above cited.

Not until the fall of 1935 did the Board overrule these cases in *Kitselman*, 33 B.T.A. 394 and *Newberry Lumber Co.*, 33 B.T.A. 150. The overruling of the cases was based on the adoption by the Board of the continuity of interest theory now contended for by the government.

The Commissioner immediately published his non-acquiescence in these cases (as to *Kitselman* case C.B. XV-1

page 36 and as to *Newberry* case see C.B. XV-1 page 39) and appealed them to the Circuit Courts of Appeal and the bureau continued its preexisting practice.

Part of his argument in the Circuit Court of Appeals in the *Kitselman* case is quoted at pages 20 and 21 of our main brief. That court adopted his argument and reversed the Board in April, 1937, its decision being reported in 89 F. (2d) 458. Kitselman, still seeking to deduct a loss (which there was an unquestioned right to deduct if there was no reorganization) petitioned this court for certiorari. One of the grounds of petition was that the *Worcester Salt Co.* case, 75 F. (2d) 251 (the same as the *LeTulle* case) was in conflict with the *Kitselman* case. The government's brief in opposition pointed out that it was not. (For quotation from that brief see taxpayer's brief in Alabama Asphaltic Co., page 15). This court denied the writ in 302 U. S. 709. Thereupon bondholders who went through depression reorganizations and were claiming losses gave up the ghost and the Statute of Limitations barred their right to claim a loss. The government also succeeded in reversing the *Newberry Lumber Co.* case in 94 F. (2d) 447, in February, 1938.

These decisions were followed by the Board and continued to represent the Treasury attitude until sometime after *LeTulle* v. *Scofield*, 308 U. S. 415 (decided January 2, 1940) was decided.

It is submitted that in the consideration and decision of doubtful questions fundamental principles of fair play ought to play a part.

That this administrative practice under which deduction of losses was denied bondholders in depression reorganiza-

tions was known to Congress and that the reorganization provisions were retained in the law in 1934 for the purpose of preventing bondholders deducting losses in the deluge of depression reorganizations then in process clearly appears. (See report p. 36 of our main brief. Also pgs. 34, 33, 32. See statement of Acting Secretary of the Treasury in Ways & Means Sub-committee Report 73rd. Cong. 2nd. Sess. p. 9.)

Separate Tax Consequences Are Not to Be Attached to a Reorganization Sale.

A reorganization plan is treated as a unit. *Helvering* v. *Bashford*, 302 U. S. 454, 458.

The Board of Tax Appeals and every Circuit Court of Appeals has repeatedly declared separate tax consequences are not to be attached to a reorganization sale. *Howard Hotel Co.*, 39 B.T.A. at p. 1153. Cases cited in 41 B.T.A. at p. 386. More than two pages would be required to cite all the cases so holding. In the quotation from its brief at page h hereof the government states this principle is well established.

Fletcher's Cyclopedia of Corporations (Vol. 15) at Sec. 7270 states:

> "In some respects a sale followed by corporate reorganization is quite different from the ordinary foreclosure or execution sale. The former has been characterized as hardly a sale at all but a mere step in a reorganization." (Citing 20 Columbia Law Review, 733, 739; 27 idem. 132; 32 idem. 668-678.)

Again at Sec. 7281 he states:

> "However, the foreclosure sale on reorganization is more or less a formal matter, a device rather than a fact."*

In *Habirshaw Electric Cable Co.* v. *Same*, 296 Fed. 875, cer. den. 265, this Court said at page 878:

> "In the case, however, of large properties, such as those at bar, where rights and relations are very complicated, a sale disconnected with a plan of reorganization is likely to prove disastrous."

In *Louisville Tr. Co.* v. *Louisville R. Co.*, 174 U. S. 674, 682 p. 683, the Court said none but bondholders can buy where large properties are involved.

This Court has held that a transaction in form of a purchase and sale may be in effect a reorganization and is so where the purchase is without money consideration. Many states have statutes providing for such reorganization.

It must not be overlooked that prior to the "sale" in the case at bar the old corporation's sole stockholder had no equity in its assets and all the equity belonged to the bondholders. *Consolidated Rock Products Co.* v. *Du Bois*, 312 U. S. 510. However he was given an interest.

Also that the trustee for the bondholders "sold" to them. The bureau has always taken the position that a loss cannot be established by public auction where the taxpayer, through agents, is buyer and seller and that in

*The amount at which a dissenting bondholder may participate does not depend on the bid price. **First National Bank v. Florsheim**, 290 U. S. 504. **Northern Pacific Ry. Co. v. Boyd**, 228 U. S. 482, 507, 508. In Corporations, 13 American Jurisprudence, Sec. 1245, it is said: "A transaction in form a purchase and sale may be in effect a reorganization or consolidation, as, for example, when the purchase is without a money consideration and upon an exchange of stock and bonds of the new company for stock and bonds of the old."

such case no sale takes place. I.T. 1181 C.B. 1 p. 141 and Dobson, 1 B.T.A. 1082 (*Cf. Higgins* v. *Smith*, 308 U. S. 473 disregarding a sale by a taxpayer to a wholly owned corporation.)

Also the payment of a bond or note is not a sale. *Hale* v. *Helvering*, 85 F. (2d) 8. The court below said the old company got credit on a debt.

As said in *Howard Hotel Co.*, 39 B.T.A. at p. 1152, the purpose of the reorganization provisions was to maintain the *status quo* in tax matters where such "transfer is primarily a matter of form and not of substance."

In the case at bar, for months prior to the "sale" Mr. Pinney was sole stockholder of the old company and the beneficial interest in its property was in the bondholders. After the "sale" Mr. Pinney and the bondholders owned all the stock of the new transferee corporatiton. The "sale" made no change in beneficial interest.

Basis If No Reorganization

In all the cases at bar except this one the government contended below that if there was no reorganization the basis was the bid price. Here it is said the basis is the fair market value of the property at the time of the transfer. (Where this is less than the cost of the bonds and bondholders were denied losses by aforesaid rulings and court decisions at the time of the transfer an injustice will be done even if this basis is adopted.)

This shift is a wise one and dictated by more mature consideration for obviously if the bid price were decided to be conclusive all future bondholders' committees would bid the full amount of the bond issue and thus secure a basis which in many cases would exceed the depre-

ciated cost of the property to the old corporation. On the other hand, bondholders wanting to write off a partially worthless debt would bid the price suitable to accomplish what they desired to write off. Also in past reorganizations, where no money passed and the bid price was fixed at a figure to enable the commissions to pay the cost of the reorganization, a glaring injustice would result from making the bid price the basis.

The reasons why market value at the time of the transfer is the basis if there was no reorganization are fully stated in the government's brief in opposition in *West Production Co.*, No. 674 herein, and reference is made to that brief.

This Court will not overlook that if the administrative practice, continued for sixteen years, is now overturned thousands of cases will be reopened and hundreds of millions of dollars in property must be now valued at the date of the reorganization sale. When one considers the questions as it affects the railroads alone the task will be appalling. Also there will be a flood of valuation litigation and negotiations and controversy extending over years.

In 1934, in commenting upon a preliminary report of a subcommittee of the Ways & Means Committee (73rd Cong. 2nd Sess., p. 9) the Acting Secretary of the Treasury said:

> "To attempt to evaluate the property received in exchange would be an enormous administrative task * * * It will be noted that exempt exchanges are strictly limited to transactions in which it would be administratively difficult to determine any gain or loss."

Consider the facts at bar. The Hotel was completed in 1928. Its cost, with additions to August 2, 1932, was $769,384.78. The Commissioner valued it as of August 2, 1932 at $370,955.32. What is the rule for valuing property in the trough of the depression?

These considerations reinforce the argument that if any change is to be made at this late date it should be by legislation where the problem can receive the thorough consideration it deserves from the standpoint of both the taxpayer and the government.

CONCLUSION.

As we have said, if a corporation cannot be reorganized when stockholders are eliminated most depression reorganizations are outside the Revenue Act, yet the amendment to the Bankruptcy Act (quoted in note at p. 8 of government brief in No. 286, *Southwest Consolidated* case) indicates Congress understood insolvent corporations were within the reorganization sections and required to use the transferor's basis in its reference to property transferred in a bankruptcy proceeding "to any person required to use the debtor's basis" (for history of this Act see page i in appendix hereof.) (The Treasury so recognized in C.B. 1938—2 at page 499.)

On page 10 of its brief the government states:

> "The proprietary interest in the old corporation was shifted from its stockholders to its creditors. By the same token, immediately after the transfer, neither an interest nor control of the property of 50% or more was retained in the prior owners, as specifically required by Section 113 (a) (7) of the Revenue Act of 1932."

The point it overlooks is that this interest shifted months before the transfer. If it had shifted a week or a day be-

fore the transfer Sec. 113 (a) (7) would, by its plain words, be clearly applicable and was obviously intended to be. *Shipowners Tugboat Co.*, 4 B.T.A. 403.

In the article on "Classification of Foreclosure Mergers As Tax Free Reorganization Exchanges," in 51 Yale Law Journal, 128, in which the cases at bar are discussed at p. 132, it is said of the continuity of interest rule:

> "As formulated, the rule requires that the owners of the equity interest[24] in the transferor corporation retain a continuing proprietary interest in the transferee corporation after the reorganization exchange."

Note 24 states as follows:

> "The stockholders own the equity interest in a solvent corporation. It is submitted that the equity interest passes to the bondholders upon insolvency."

The note concludes at p. 137:

> "Thus it would seem that there has been a reorganization in these receivership cases both within the literal definition in Section 112 and the underlying purpose of the tax free exception since no realized gain has been shorn from the business res."

One very important point not to be overlooked is that Section 113 (a) (7) is also designed to prevent the basis being stepped up. For invested capital, upon which war excess profits taxes are based, this is vital. Invested capital is defined as what is invested in the business or the value of property paid in for stock at the time paid in. War plants, oil companies and companies such as LaBelle Iron Works, 256 U. S. 377, which have greatly appreciated in value will be paid into new corporations to get this increased value as an invested capital basis if the meaning of "reorganization" in Section 113 (a) (7) is so restricted as to make it easy to avoid this section. It cuts both ways.

For example, if 50 per cent of the stock in the new corporation must be issued for stock in the transferor (as the government here claims) before Section 113 (a), (7) is applicable it will be an easy matter to avoid it and as a result step up the basis of property by merely causing 51 per cent of the stock of the transferee to be issued to the same people who own the transferor, for new money or other considerations.

As to the quotation from the Committee report on pages 29 and 30 of government brief in No. 286 herein, it is important to note transfers of bonds in reorganizations were exempted from the stamp tax for the reason that the changes were purely formal. Section 724 of the 1932 Act read in part: "Provided further, that the tax shall not be imposed on deliveries or transfers of bonds in connection with a reorganization." Thus indicating Congress understood such a thing did not affect the reorganization. It knew most bonds were being then changed into stock. The Committee in its report on the 1932 law said: "Transfers of bonds in connection with tax free corporate reorganizations are exempted." (C.B. 1939—1, Part II, p. 531.)

The continuity of interest theory should not be read into the statute beyond its present borders. Since 1934 it has provided a "statutory merger" is a reorganization. In many states a statutory merger may be made if the stockholders of one of the merging companies take only bonds. Yet, as to them, the statute does not mean what it plainly and unambiguously says.

We believe the Board was correct in its decision that the acquisition of the furniture and fixtures was not in a reorganization for the reasons stated by the Board and on page 10 of the government's brief herein and accept that part of the decision.

We ask that the decision of the Board of Tax Appeals be affirmed and that of the Circuit Court of Appeals reversed.

All of which is respectfully submitted.

JOHN E. HUGHES,
THOMAS R. DEMPSEY,
Attorneys for Petitioner

FRANK MERGANTHALER,
Of Counsel.

APPENDIX A.

Remarks of Hon. George A. Paddock of Illinois in the House of Representatives Monday, Aug. 25, 1941.

Mr. Paddock: Mr. Speaker, the Government of the United States, with its almost complete control over the property of its citizens, owes them a high degree of fairness and honesty in exercising these great powers. In recent cases now before the courts our Treasury Department has attempted to tax as "profitable" transactions where actual losses were plainly evident, and conceded by the Department. Because of these attempts to collect taxes without any justification except a technical and arbitrary interpretation of the law, I have introduced H. R. 5617.

In brief, my bill prevents the attempt to collect profits taxes on transactions involving actual losses, following reorganizations by bondholders. It directly protects hundreds of thousands of individuals and corporations, former purchasers of bonds, who took over in reorganization the property their securities covered. It clarifies the present law which our Treasury Department interprets to authorize profit taxes on differences between reorganization values and later resales, even though this resale value was actually less than the original cost to the taxpayers.

For a concrete case illustrating the injustice which H. R. 5617 will correct, I cite the Federal Land Bank of Milwaukee, which issued bonds for which it secured about $15,000,000, mostly from small investors. It loaned this money on farm mortgages. In 1926 it was declared in-

solvent, and in 1932 the Farm Loan Board approved the transfer of its assets to a new corporation organized by the bondholders. This transfer was by means of a public sale at which the bondholders were the only bidders, and the nominal upset bid price was $2,351,000. No money passed. The bondholders might just as well have bid $15,000,000. It would have cost them no more, and would have eliminated the controversy.

Eventually the reorganized company liquidated the mortgages for about $10,000,000, so there was an actual loss of over $4,000,000. If the transfer of the assets of the land bank to the new company be treated as a reorganization, this loss will be given effect. Otherwise, a tax will be due on an alleged profit of $7,649,000. The bondholders were in control before and after the transfer.

In 1932 the Treasury ruled that there was a "reorganization," and the bondholder could deduct no loss. Now that the statute of limitations has run against the bondholders, the Treasury has reversed its position, and claims its former ruling was wrong, that a deductible loss was realized in 1932, and a new base for the computation of profit and loss and the calculation of depreciation was then established.

The decision depends on the definition of reorganization. If there is a reorganization, the new company assumes the old company's base, and the transaction is not considered completed as to bondholders and stockholders. They retain the original cost as a basis of computing profit or loss when they dispose of the substituted securities they receive in the reorganization.

The Board of Tax Appeals has denied the Treasury's present contention. So have the Circuit Court of Appeals for the Second, Fifth, and Tenth Circuits. However, it has been sustained by the Circuit Court of Appeals for the Ninth and Eighth Circuits, and the decision of the Ninth Circuit in the case of Marlborough House is now pending in the Supreme Court.

I submit, Mr. Speaker, that we ought not to subject taxpayers to the hazard of what the Supreme Court may decide, but should put the question at rest now by adopting this amendment to settle the matter beyond doubt.

I do not know how many people, poor and rich, will be protected against unjust taxation by this bill. To calculate the number would involve a tabulation of the countless reorganizations which followed the crash of 1929. If we include the policyholders of the insurance companies, which invested many millions in these bonds, almost every American family will benefit somewhat by its provision.

Best of all, by enacting this bill, we will prevent the force of our Government from being used, under color of law, to attempt unjust transactions at the expense of its own citizens.

APPENDIX B.

Analysis of Decision Below

The court below in its opinion states:

> "Neither the Hotel Company nor the Operating Company got anything for its property except the satisfaction or partial satisfaction of certain indebtedness. Neither received any stock or bonds of the taxpayer. Neither retained any stake or proprietary interest in the corporate enterprise in which theretofore it had engaged. Hence, the transactions whereby the taxpayer acquired the property were mere sales or exchanges."

It does not follow that no reorganization took place because the transferor corporation did not get anything for its property. As Judge Learned Hand, with this opinion before him, pointed out in *Helvering* v. *New Haven & Shore Line Ry. Co.*, 121 F. (2d) 985, page 987:

> "It is true that the Taxpayer did not deliver its shares to the predecessor, but to the predecessor's bondholders; but the section does not declare that the buyer must deliver to the seller; only that the buyer shall acquire the properties from the seller in exchange for the buyer's shares. It would be a peculiarly fatuous formality to require the shares to pass through the seller to its shareholders; and the Commissioner does not so assert."

Because of the mistake pointed out by Judge Hand the court below reaches the conclusion, "hence the transactions" whereby the taxpayer acquired the property "were mere sales or exchanges."

As to the attempt to isolate the trustee's sale see page 31 hereof. Also the extinguishment of the bonds was neither a sale nor an exchange. *Fairbanks* v. *United States*, 306 U. S. 426; *Hale* v. *Helvering*, 85 F. (2d) 8.

The court below then states the *Kitselman* and *Newberry Lumber* cases were "in effect overruled by *Le Tulle* v. *Scofield*." This is a mere fiat wholly devoid of a single line of reasoning.

The court below also states:

> "In the case at bar, the transferor's stockholders get nothing."

How erroneous this is appears at pages 10 and 11 of this brief.

The court below also states an interest of 50 per cent or more did not remain in any of the same persons as before. "For prior to the transfers the taxpayer had no interest or control in any of the property, but was merely a creditor of the owners."

This statement is also incorrect for, because the old corporations were insolvent, taxpayer had a 95 per cent beneficial interest in its property prior to the transfer, as fully pointed out in the foregoing brief and also control over it.

The above is the reason that the second and tenth Circuits refused to follow this opinion.

APPENDIX C.

Page to Page Answer to Government Brief in No. 286 Therein (Southwest Consolidated Case)

Since the government makes the above its main brief the following analysis of it is submitted:

On page 6 the government says its position: "at the same time is fair to creditors since depreciation in the value of their individual investments would be reflected in a capital loss on exchange of their claim for stock". The government procured judicial decisions denying them this loss and, after the Statute of Limitations has barred their right to claim it, now asks the court to give it a tax windfall and tax as income any part of this loss a creditor chances to recover.

As to the bottom of page 6 and top of page 7, the only question is whether the creditors had either a 50 per cent interest or control in the property prior to the transfer—not whether they were "equivalent of the corporation or its stockholders before the foreclosure sale."

At the bottom of page 8 it cites the recent G.C.M. 22528, which holds that if a bond is exchanged for stock the debt is "cancelled." This must be decided by the courts in cases in which it arises. It should not be decided without mature consideration and the benefit of the expert view of the Board of Tax Appeals.

Answering the statement on page 11, it is obvious that *LeTulle* v. *Scofield* did not establish the principle that a

creditor interest in an insolvent corporation was not a proprietary interest because the corporation in that case was not insolvent. If it had established such principle the Board would not have decided as it did in the cases now at bar.

On page 12 it is stated where an existing investment is continued in a different form "it is understandable that the owners of that investment should be permitted to retain the same basis for tax purposes."

If this statement is carried to its logical conclusion, the taxpayer here should prevail for the bondholders and the sole stockholder were the only persons interested both before and after the transfer.

As an argument for fairness, page 14 is inapplicable since no loss was allowed and the Statute of Limitations now bars the right to claim one.

The rule stated on page 15 to be established by *LeTulle* v. *Scofield* is correct but that is not the situation in the cases at bar. With reference to the last paragraph on page 15 it was not the transfer but the insolvency of the old company that shifted the interest and also the control. (See page 27 hereof). As to page 17, the creditors acquired the equity interest before they surrendered their claims. Also the bondholders became equitable owners of the old company's assets on its insolvency and retained such interest after the transfer.

As to the claim on page 19 that the transaction may be treated as involving two separate steps (1) the sale and (2) the transfer to the new company, the cases hold the con-

trary. As stated in the government brief in the *Kitselman* case. (quoted page 15 taxpayer's brief in No. 328):

> "It has long been established, in the application of the pertinent reorganization provisions, that the component steps of what may be regarded as a single general plan looking to the reorganization of a corporation will not be treated separately".

In *Commissioner* v. *Kolb*, 100 F. (2d) 920, 925:

> "The Commissioner's brief properly contends that all the component steps of the plan should be regarded as a single transaction."

Page 20 treats the Committee as a separate purchaser whereas it was a trustee for the new company. That the purchasing committee buys and holds the property in trust for and must convey it to the new corporation see Fletcher, Vol. 15, Sec. 7280. (1938 edition.)

The position taken in note 13 on page 23 is untenable for the reasons stated on page 11 hereof.

On page 26 it is suggested that if the assets before the sale rise in value to exceed the debts the stockholders are entitled to the excess. Who knows such a case? Certainly the case at bar was not such. "Taxation," as this court has said, "is eminently practical."

With reference to the last paragraph on page 26 a default had taken place here and upon that event equity transferred the equitable title to the property to the bondholders and also the control of the property to the bondholders.

At the bottom of page 27 and top of page 28 an attempt is made to get around this by saying a taxable shift took place. The government in the *Kitselman* case established

the contrary. Also bonds are debts and they are not deductible as worthless debts where they are exchanged for valuable stock. The case of *Helvering* v. *Midland Ins. Co.*, 300 U. S. 215 is analyzed in the government's opposition to taxpayer's petition No. 674 herein (West Production Co.) and this analysis shows it inapplicable here. Also it does not deal with a reorganization.

As to pages 28 to 31 a sufficient answer is that the Committee Reports expressly state the transition from bondholder to stockholder might be made and a reorganization exist.

If as sale, which takes place in nine out of ten reorganizations, is held to take the case out of the reorganization provisions they will be largely nullified.

The legislative history of the section of the Bankruptcy Act quoted in note on p. 8 of government brief in No. 286 herein (Southwest Consolidated Co.) is that the decision in *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, was construed to mean if debt was cancelled or reduced and thereby the debtor was rendered solvent the debt cancelled was taxable income. Tax on such "income" being more than they could pay, bankrupts applied to Congress for relief and U.S.C. Title 11, Sec. 795 was enacted declaring no taxable income was realized from such cancellation. The treasury demanded the basis be reduced by the amount of debt cancelled but Congress in the Statute quoted on p. 8 of the government's brief in N.o 286 herein provided this reduction should not go below the value of the property. (For Committee Report see C.B. 1940—2 p. 598, 599, 600.)

No. 503

In the Supreme Court of the United States

OCTOBER TERM, 1941

PALM SPRINGS HOLDING CORPORATION, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR RESPONDENT

In the Supreme Court of the United States

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MEMORANDUM FOR RESPONDENT

The Government does not oppose the granting of a writ of certiorari in this case. The question presented is essentially the same as that presented in *Commissioner* v. *Southwest Consol. Corp.*, 119 F. (2d) 561 (C. C. A. 5); *Commissioner* v. *Alabama Asphaltic Limestone Co.*, 119 F. (2d) 819 (C. C. A. 5); and *Commissioner* v. *Bondholders Committee*, 118 F. (2d) 511 (C. C. A. 9). The first two of these cases (Nos. 286 and 328, respectively) are pending on the Government's petition for certi-

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orari, and the third case (Nos. 128, 129) is pending on the taxpayers' petition for certiorari.

In the instant case the taxpayer is a corporation formed by a committee of bondholders of the Palm Springs Hotel Company (R. 25–27). It acquired the hotel buildings of the Palm Springs Hotel Company at a foreclosure sale for a bid price of $61,800, of which $18,767.96 was paid in cash and the balance by surrender of the bonds (R. 27). Among the assets acquired at this foreclosure sale was a chattel mortgage held by the Palm Springs Hotel Company upon the furniture and fixtures in the hotel, which were owned by the Palm Springs Hotel Operating Company[1] (R. 23, 28). The Operating Company had been operating the hotel under a lease from the Palm Springs Hotel Company (R. 23). Several weeks after the first foreclosure sale the petitioner foreclosed this chattel mortgage and acquired the furniture and fixtures for a bid price of $20,179.25 (R. 28). At that time the Operating Company was indebted under its lease and mortgage in the amount of $77,918.79, and the furniture and fixtures constituted all of its property (R. 28). The question presented is whether the taxpayer may take as its basis for depreciation the basis of these assets in the hands of the Palm Springs Hotel Company and the Palm Springs Hotel Operating Company. The court below sustained the Commissioner's determination that the

[1] Later known as El Mirador Hotel Operating Company.

basis for depreciation was the cost of the property at the foreclosure sale. It rejected the taxpayer's contention that the assets were acquired in connection with a "reorganization" as that term is defined by Section 112 (i) of the Revenue Act of 1932 and that the basis was to be determined under Section 113 (a) (7) of the Revenue Act of 1932.

A contrary result has been reached in the Fifth Circuit in the *Southwest Consol. Corp.* case, *supra*, and in the *Alabama Asphaltic Limestone Co.* case, *supra;* in the Second Circuit in *Commissioner* v. *New Haven & Shore Line R. R. Co.*, decided July 16, not yet officially reported but found in 1941 C. C. H., Vol. 4, par. 9600; and in the Tenth Circuit in *Commissioner* v. *Cement Investors, Inc.*, and *Commissioner* v. *Newton*, decided July 24, 1941, not yet officially reported but found in 1941 C. C. H., Vol. 4, pars. 9614, 9615. Accordingly, although we believe the instant case was correctly decided by the court below, we do not oppose the granting of the writ in view of the conflict among the circuits and the importance of the question in the administration of the revenue laws.

Respectfully submitted.

CHARLES FAHY,
Acting Solicitor General.

SEPTEMBER, 1941.

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BRIEF FOR THE RESPONDENT

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes involved	3
Statement	3
Argument	8
Appendix	12

CITATIONS

Cases:

Commissioner v. *Alabama Asphaltic Limestone Co.*, 119 F. (2d) 819, certiorari granted, October 13, 1941, No. 328, this Term 8, 9

Commissioner v. *Bondholders Committee, Marlborough Investment Co.*, 118 F. (2d) 511, certiorari granted, October 13, 1941, Nos. 128 and 129, this Term 8

Commissioner v. *Kitselman*, 89 F. (2d) 458, certiorari denied, 302 U. S. 709 10

Commissioner v. *Southwest Consol. Corp.*, 119 F. (2d) 561, certiorari granted, October 13, 1941, No. 286, this Term 8

LeTulle v. *Scofield*, 308 U. S. 415 9

United States v. *Galveston-Houston Electric Co.*, 84 F. (2d) 516, certiorari denied, 299 U. S. 590 9

Statutes:

Revenue Act of 1932, c. 209, 47 Stat. 169:

Sec. 112 14

Sec. 113 14

Revenue Act of 1934, c. 277, 48 Stat. 680:

Sec. 112 (U. S. C., Title 26, Sec. 112) 12

Sec. 113 (U. S. C., Title 26, Sec. 113) 12

Sec. 114 (U. S. C., Title 26, Sec. 114) 13

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The memorandum opinion of the United States Board of Tax Appeals (R. 22–35) is unreported. The opinion of the Circuit Court of Appeals (R. 88–95) is reported in 119 F. (2d) 846.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered May 14, 1941. (R. 96.) The petition for a writ of certiorari was filed August 11, 1941,

and was granted on October 13, 1941. The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by Act of February 13, 1925.

QUESTION PRESENTED

Pursuant to plan, a bondholders protective committee formed the taxpayer, a new corporation, which acquired the assenting bonds and issued in return therefor, and for certain other considerations, its preferred and common stock. Thereupon the taxpayer purchased the mortgaged assets from the indenture trustee, paying the bid price in part by a surrender of the bonds.

The taxpayer subsequently purchased at foreclosure sale certain personal property which had been mortgaged to the debtor corporation by a third company as security for a lease; this lease and chattel mortgage had been pledged as additional security for the debtor's bonds and had been included in the property bought from the indenture trustee.

The question is whether the basis of the assets, for purposes of computing depreciation, is the same as it would be in the hands of the debtor corporation and the third company under Section 113 (a) (7) of the Revenue Act of 1932.[1] The answer

[1] This Section, made applicable by Section 113 (a) (12), of the Revenue Act of 1934, is the same as Section 113 (a) (7) of that Act.

depends upon whether the transactions constituted reorganizations within the definition of Section 112 (i) (1) of the Revenue Act of 1932.

STATUTES INVOLVED

The statutes involved are set forth in the Appendix, *infra*, pp. 12–15.

STATEMENT

The Palm Springs Hotel Co., the taxpayer's predecessor corporation, owned the El Mirador Hotel at Palm Springs, California. This company (hereafter referred to as the Hotel Company) had outstanding in 1932 an issue of approximately $300,000 face amount of first mortgage bonds, secured by a lien on its real property; as of September 1, 1931, its outstanding stock consisted of 3,213 shares of preferred and 110 shares of common. (R. 23.)

The Hotel Company also owned 738 shares of a total of 1,253 shares outstanding of the Palm Springs Hotel Operating Co, (hereafter referred to as the Operating Company).[2] This company operated the hotel under a lease from the Hotel Company. It also owned the furniture and fixtures in the hotel, which it mortgaged to the Hotel Company as security for performance of the terms of

[2] The Palm Springs Hotel Operating Co. subsequently changed its name to El Mirador Hotel Operating Company. (R. 23.)

the lease. The lease and chattel mortgage were assigned and pledged by the Hotel Company as part of the security for the bond issue. (R. 23–24.)

In the spring of 1931, both companies were in financial difficulties and unable to meet their respective obligations. Each levied an assessment of $20 per share on its capital stock. (R. 24–25.)

On August 20, 1931, a bondholders committee was formed, and bonds of a face value of $167,500 were deposited with the committee under the terms of the deposit agreement. (R. 25.)

The next month both companies sold for nonpayment of the assessment, and themselves bought in, all of their shares of stock with the exception of certain shares owned by Warren B. Pinney, president of the two companies. Pinney paid the assessments on five shares each of the common and preferred stock of the Hotel Company and on ten shares of the stock of the Operating Company. Thereafter, he was the sole stockholder of each of the two companies. (R. 24–25.)

The Palm Springs Holding Corporation, the taxpayer, was incorporated under the laws of California on April 1, 1932. Its authorized capital stock consisted of 3,000 shares of 6% noncumulative preferred stock of a par value of $100 each and 7,500 shares of common stock without par value. (R. 25–26.)

In accordance with a plan of reorganization, set forth in a letter from the bondholders com-

mittee, six shares of the taxpayer's preferred stock and four shares of the common were issued to assenting bondholders for each $1,000 bond. (R. 26.) In addition, all of the taxpayer's common stock, not required to be issued in exchange for bonds, was issued to R. D. Lacoe in return for his agreement to pay the costs of incorporating the taxpayer up to $1,000 and for his agreement to lend money to the taxpayer, as set forth in the plan of reorganization. (R. 27.) Since Lacoe was also a holder of $119,000 of bonds of the Hotel Company, he likewise received a distribution of six shares of preferred stock and four shares of common stock for each $1,000 face amount of his bonds. (R. 26–27.)

The aggregate disfribution of the taxpayer's securities, in accordance with the plan outlined, was as follows (R. 26):

	Face Value Bonds Exchanged.	Stock of Taxpayer Issued.	
		Preferred Shares.	Common Shares.
Bondholders	$173,000	1,038	692
R. D. Lacoe	119,000	714	476
R. D. Lacoe	none	----------	6,332
	$292,000	1,752	7,500

Before the actual issuance of any of these shares, Lacoe transferred 1,000 shares of the common stock to Pinney, then the sole remaining stockholder of the two companies, for his services in the reorganization and as an inducement to con-

time as manager of the hotel. (R. 29.) None of the stock of the taxpayer, however, was issued to any stockholder or former stockholder of the Hotel Company or the Operating Company for any rights any of them might have had as stockholders of the companies. (R. 29–30.)

On or about May 21, 1932, the indenture trustee declared the principal of the bonds due and payable. On July 15, 1932, the trustee sold all of the properties of the Hotel Company to the highest bidder pursuant to the terms of the indenture. The taxpayer was the successful bidder and acquired all the properties of the old corporation, including the lease and chattel mortgage for a bid price of $61,800. This price was satisfied by the payment of $18,787.96 cash, and by the delivery to the trustee of bonds of a face value of $292,000 for the balance. (R. 27.)

The properties were conveyed to the taxpayer on July 15, 1932. Thereafter, the taxpayer instituted foreclosure proceedings against the Hotel Company and the Operating Company; obtained a judgment of $77,918.79 against the Operating Company; and on August 2, 1932, bought in the fixtures and furniture, comprising all the properties of the Operating Company, at foreclosure sale for a bid price of $20,179.25. (R. 28.)

The total amount of bonds of the old corporation outstanding in July 1932 was $309,000. (R. 23.) The cost of the buildings to the old cor-

poration, including all additions up to 1932, was $686,731.97. The cost of the furniture and fixtures to the Operating Company, acquired by the taxpayer on August 2, 1932, including all additions up to that date, was $232,544.10. Additions made by the taxpayer up to May 31, 1936, cost it $82,652.81 with respect to the real estate and $40,485.18 with respect to the personalty, making the aggregate figures $769,384.78 and $273,029.28. (R. 29.)

The Commissioner, in determining a deficiency in the taxpayer's income and excess profits tax for the fiscal year ended May 31, 1936, disallowed depreciation deductions on both the real estate and the personal property, which had been taken on a basis of the foregoing figures. The Commissioner, rejecting the contention that these assets had been acquired in a non-taxable reorganization, used as the basis the cost of the assets to the taxpayer, measured by their value upon acquisition plus the cost of additions. (R. 13–15.) The Commissioner's basis was $370,955.32 for the real estate and $138,108.67 for the personalty.

The Board of Tax Appeals sustained the Commissioner's determination with respect to the personal property but rejected it with respect to the realty. Upon cross-petitions for review, the Circuit Court of Appeals sustained the Commissioner on both points.

ARGUMENT

A.

This case presents the same fundamental problem as that before the Court in its companion proceedings: *Commissioner* v. *Southwest Consol. Corp.*, 119 F. (2d) 561 (C. C. A. 5th), certiorari granted October 13, 1941, No. 286, this Term; *Commissioner* v. *Alabama Asphaltic Limestone Co.*, 119 F. (2d) 819 (C. C. A. 5th), certiorari granted October 13, 1941, No. 328, this Term; and *Commissioner* v. *Bondholders Committee, Marlborough Investment Co.*, 118 F. (2d) 511 (C. C. A. 9th), certiorari granted October 13, 1941, Nos. 128 and 129, this Term. The Government's position has been fully developed in its brief in the *Southwest Consolidated* case, to which the Court is respectfully referred.

B.

As in our *Alabama Asphaltic* and *Bondholders Committee* briefs, however, we wish to direct the Court's attention to those points of difference which exist in this case:

(1) In all of the other cases, the assets in question were bought in by the committee and then transferred to the new corporation in return for a distribution of its securities in accordance with the plan proposed. Here, the reverse procedure was employed. The new corporation was formed first; the deposited and assenting bonds were

transferred to it; the new corporation's securities were issued as the plan contemplated; and thereafter, the new corporation acquired the mortgaged assets directly at the trustee's and foreclosure sales.

The transaction thus fits the literal language of clause A of the statutory definition of a reorganization—i. e., "the acquisition by one corporation of * * * substantially all the properties of another corporation." Revenue Act of 1932, Section 112 (i) (1) (a).[3] But as we pointed out in our *Alabama Asphaltic* brief (p. 7), the conclusion would not alter the ultimate result. The controlling fact is that irrespective of the literal language of the statute, the absence of a continuity in the new corporation of the proprietary interest in the old takes the case beyond its purview. *LeTulle* v. *Scofield*, 308 U. S. 415. As the Board expressly found, none of the securities of the new

[3] The taxpayer also argues that clause B is applicable. However, even if we assume that the transfer was made by the old corporation, rather than by the indenture trustee or the sheriff at the judicial sale [but cf. *United States* v. *Galveston-Houston Electric Co.*, 84 F. (2d) 516 (C. C. A. 1st), certiorari denied, 299 U. S. 590], neither the old corporation nor its stockholders were thereafter in control of the new company within the requirement of clause B and the definition of Section 112 (j). In fact, "control" within the statutory definition was not even in the participating creditors since the majority of the new common stock had been distributed, for a consideration other than an exchange of bonds, to R. D. Lacoe and W. B. Pinney. For the same reasons, Section 112 (b) (5) would not be applicable.

corporation was issued in return for the former stock interests. The proprietary interest in the old corporation was shifted from its stockholders to its creditors. By the same token, immediately after the transfer, neither an interest nor control of the property of 50% or more was retained in the prior owners, as specifically required by Section 113 (a) (7) of the Revenue Act of 1932.

(2) The situation with respect to the personal property is unique in that it involves property which did not belong to the corporate mortgagor and which was not itself pledged under the bondholders' mortgage. The personalty was owned by the Operating Company. It was mortgaged as security for the leasehold obligation running to the Hotel Company, and both obligations were pledged to the bondholders. But the bondholders had no direct rights or interests either in the Operating Company itself or in its assets. They were creditors of a corporation holding, as part security for their debts, claims which the corporation had against a third company.

Consequently, the Board of Tax Appeals, even while holding that the bondholders were "stepped up" to the position of stockholders of the Hotel Company under the theory of *Commissioner* v. *Kitselman*, 89 F. (2d) 458 (C. C. A. 7th), certiorari denied, 302 U. S. 709, concluded that the metamorphosis ceased at that point. The Board held that the bondholders did not become "stock-

holders" of the Operating Company and could not be considered as owners of the physical assets of that company. The Board recognized that when the taxpayer took over the assets of the Hotel Company, it became the corporate owner of the lease and chattel mortgage. Its subsequent foreclosure was no different from that of any other foreclosure by a secured corporate creditor—a proceeding which clearly is not a "reorganization".

C.

The Commissioner in this case employed a valuation to measure the cost of the assets to the taxpayer and not the bid price at the foreclosure sale. The correctness of the valuation has not been challenged. If the Government is sustained, therefore, further proceedings for a determination of the taxpayer's cost in this case will not be called for.

Respectfully submitted,

CHARLES FAHY,
Solicitor General.

SAMUEL O. CLARK, JR.,
Assistant Attorney General.

J. LOUIS MONARCH,
SAMUEL H. LEVY,
Special Assistants to the Attorney General.

JANUARY, 1942.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * * *

(5) *Transfer to corporation controlled by Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. * * *. (U. S. C., Title 26, Sec. 112.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(8) *Property acquired by issuance of stock or as paid-in surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

* * * * *

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * *

(12) *Basis established by Revenue Act of 1932.*—If the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis thereof, for the purposes of the Revenue Act of 1932 was prescribed by section 113 (a) (6), (7), or (9) of such Act, then for the purposes of this Act the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

* * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided. * * *. (U. S. C., Title 26, Sec. 113.)

* * * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of

any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property. * * *.

(U. S. C., Title 26, Sec. 114.)

Section 112 (j) is identical with Section 112 (j) of the Revenue Act of 1932, *infra*.

Revenue Act of 1932, c. 209, 47 Stat. 169.

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(i) *Definition of reorganization.*—As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred. * * *.

(j) *Definition of control.*—As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(7) *Transfers to corporation where control of property remains in same persons.*—If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

The relevant provisions of Regulations 86 under the Revenue Act of 1934 are set forth in the Appendix to our brief in the *Southwest Consolidated* case. Regulations 77 under the Revenue Act of 1932 do not contain provisions material to the question in issue.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

No. 503

PALM SPRINGS HOLDING CORPORATION, *Petitioner*,

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF AMICUS CURIAE OF STATE OF OHIO.

THOMAS J. HERBERT,
Attorney General of Ohio.

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INDEX.

	Page
Interest of the Superintendent of Insurance of Ohio in case at bar and Alabama Asphaltic and Southwest Consolidated cases	1
Point I. Government's unjustified shift in its construction of tax statute in question has broken faith with thousands of bondholders, resulting in great loss to them	2
Point II. Possible great loss to Federal Revenue if Government's construction of tax statutes is upheld	3
Point III. Unjust results to be produced if Government's construction prevails	4
Point IV. Stamp Tax Regulations promulgated by Secretary of Treasury refute Government's construction of statute	4
Point V. Government attempts to distort rule of Le Tulle v. Scofield	6
The Government's Contention That There Can be No Reorganization Under Sec. 112 i (1) of the 1932 Act Unless the Stock of the Transferor is in Substance Exchanged for Stock of the Transferee Cannot be Upheld Without Altering the Plain Words of the Statute	8
Conclusion	10
Appendix to explain Point II	
Effect of Rule of Le Tulle v. Scofield	12

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On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF AS AMICUS CURIAE FOR STATE OF OHIO.

On behalf of thousands of holders of insurance policies issued by American Insurance Union, organized under the Fraternal Insurance law of Ohio, in the State of Ohio and in twenty-seven other States, the State, through its Superintendent of Insurance, is vitally interested in the outcome of the case at bar as well as the *Southwest Consolidated Corporation* case, Docket No. 286, and *Alabama Asphaltic Limestone Company* case, Docket No. 328.

Reasons for this interest may be found in the testimony on his behalf on pages 479 to 486 of the House Hearings on the Revenue Act of 1941 (Note also the testimony in the Senate Hearings, pages 234 and 235).

The Superintendent of Insurance of Ohio and the Attorney General as his Counsel, in drafting the plan to reorganize the property of the American Insurance Union, relied upon the construction of Reorganization, Sections 112 *et seq.*, of the Revenue Act, as contended for by the United States Department of Justice, in the *Kitselman* case, (see quotations in respondent's brief in *Alabama Asphaltic* case, Docket 328—Pages 14-16), which was adopted by the Seventh Circuit Court of Appeals (89 Fed. 2d 458), in which the court denied certiorari (302 U. S. 709). The Government now repudiates its own construction there approved by the court to the great prejudice of those represented by the Superintendent of Insurance in that if this Court now confirms the Government's repudiation, the common stock of the transferee, held by the Superintendent for the Policyholders, will have little or no value because without the predecessor's basis for depreciation (to which the Government said it was entitled under the rule of the *Kitselman* case), its earnings are taken to pay income and excess profits taxes.

The Treasury has suggested to members of the Ways & Means and Senate Finance Committees that no legislation be considered until this case and its companion cases are decided by this court because their decision might render legislation unnecessary.

The Court's attention is directed to the following points:

Point I.

By uniform Treasury rulings and court decisions holding a tax-free reorganization took place in which neither gain nor loss was recognized for the purpose of the United States Income Tax Law, losses in hundreds of reorganizations have been denied to bond-holders. The Commission

did not claim these decisions were erroneous until long after the Statute of Limitations barred the bond-holders' rights to deduct these losses. In other words, so far as such an agreement is possible, these bond-holder-taxpayers and the Bureau of Internal Revenue agreed upon the basis of the assets in the hands of the transferee corporation (such as Petitioner here) at the time of these reorganizations, made necessary by the economic depression, following 1929. The price the bond-holder-taxpayers paid for that agreement was inability to deduct their large losses. Now that this price cannot be regained by or returned to them, because of the bar of the period of limitations, the Revenue Bureau appears to seek to repudiate this so-called agreement.

Point II.

The consequences of upholding the Government's contention in the case at bar may adversely affect the public revenue where taxes are based upon invested capital. Many reorganizations, under the then existing rulings, of very large corporations were carried on in the prosperity period from 1924 to 1929 when values were greatly enhanced. Under the present excess profits tax the invested capital base as well as basis for other purposes is that of the transferor—if they were so-called tax-free reorganizations. An unduly restrictive construction of the word at this time will make it appear many of them were not reorganizations and enable them to step up the basis of the property acquired for all purposes. The rule cuts both ways. (*La Belle Iron Works* v. *United States*, 256 U. S. 377, 385, shows the value of the property was about $10,000,000 more than the stockholders had invested.) Obviously if the scope of this statute is now narrowed by the unduly restrictive construction of the word "reorganization," a very wide door will be opened to stepping up values for invested capital purposes for those corporations reorganized during the boom period of the 1920 decade as they can use the appreciated values at the time of reorganization instead of the

restricted predecessor's value. I. R. C. Sec. 718(a)(2), 113(a) 7, 113(b) 2. This is a time when the interest of the revenue demands a liberal construction of this Statute. For some cases construing it under the profits tax provisions of the first World War see page 7 of petitioner's reply brief herein. The Treasury is now urging before Congress that the invested capital base be the sole basis for credit against the 1940 excess profits tax law. Therefore, now this Court should not grant a loophole to the great corporate taxpayers to boost their invested capital by taking advantage of the high market values in the 1920 decade where such corporations were reorganized during that period. See Appendix for further explanation of this point.

Point III.

The effects of upholding the government's contention will be very sweeping and produce unjust results. One concrete example appears in the speech of Representative Paddock, in the House of Representatives, quoted in Appendix A of the reply brief for the petitioner herein which your honors are requested to read.

Point IV.

It has come to our attention that regulations 71, Article 125, promulgated by the Commissioner of Internal Revenue and approved by the Secretary of the Treasury in July, 1932, construing the stamp tax provisions of the Revenue Act, under the caption "Definitions," reads as follows:

> "The term 'reorganization' in general, includes those business arrangements whereby the stocks and bonds of a corporation are readjusted as to amount, income, or priority, or the property is sold to a new corporation for new stock and bonds, *or is sold by the foreclosure of a mortgage upon it to the purchaser who buys for himself and his associates, and the various proceedings and transactions by which succession of corporations is brought about* and also the proceedings by which existing corporations are continued under a different organization without the creation of a new corporation"; (Italics ours.)

This regulation remained unchanged from 1932 until the issuance of new regulations in November, 1941. As pointed out at page 11 of respondent's brief in the Southwest Consolidated, Congress has reenacted or revised Revenue Acts nine times since 1932. While this regulation remained in force without making any change in it. *Cf. Helvering* v. *Winmill*, 305 U. S. 79, 83.

The Act did not exempt transfers of stock in reorganizations from stamp tax but did in Sec. 724 exempt transfers of bonds "in connection with a reorganization (as defined in section 112 of the Revenue Act of 1932)". (See petitioner's reply brief page 37.)

At the bottom of page 15 of its brief herein the Government states:

> "Regulations 77 under the Revenue Act of 1932 do not contain provisions material to the question in issue."

Surely this statement overlooks the relevant provisions of the regulations. For example Art. 574 of Regulations 77 states:

> "If two or more corporations reorganize, for example * * * the acquisition by the Y corporation * * * of substantially all the properties of the X corporation."

All the following regulations promulgated under the proceeding Revenue Acts, in which clause A of the definition was enacted in terms identical with the 1932 Act stated the acquisition by one corporation of substantially all the properties of another was a reorganization.

Art. 1574 of Reg. 65 (1924)
Art. 1574 of Reg. 69 (1926)
Art. 574 of Reg. 74 (1928)
Art. 574 of Reg. 77 (1932)

See also G. C. M. 1753 C. B. VI-1 p. 138 and G. C. M. 3827 C. B. VIII-2 p. 114. *National Pipe & Foundry Co.*, 19 B. T.

A. 242, 250. *Robert D. Green*, 24 B. T. A. 719, 725 (decided in 1931).

This background of administrative construction upholds the holding in *Minnesota Tea Co. v. Commissioner*, 76 F. (2d) 797 at p. 800 that Congress approved "the long continued administrative construction of the language of the definition".

Point V.

The Government here seeks to make the rule of *Le Tulle v. Scofield* work in reverse and apply it to the securities owned in the transferor immediately before the transfer (rather than to the securities received from the transferee as it was there announced). In that case the court said in 308 U. S. at page 420:

> "And where the consideration is represented by a substantial portion of stock, and the balance in bonds the total consideration received is exempt from tax under Secs. 112 (b)(4) and 112 (g) 45 Stat. 816, 818. Helvering v. Watts, 296 U. S. 387."

If it be assumed (but not conceded) that the rule works in reverse and applies to the nature of the interest exchanged, as the Government contends, nevertheless taxpayer in this case must prevail because its sole stockholder received a substantial part of the stock of the transferee. Hence we have here the reverse of the above quotation.

There is no support in the Statute for the claim that he must have received this stock in the transferee qua stockholder of the transferor corporation. (If he had, presumably the Government would concede a reorganization took place.)

It seems to us the Government's whole argument in the case at bar thus boils down to the claim that the case at bar is not a reorganization solely because the sole stockholder of the transferee did not receive these 1000 shares in the transferor qua stockholder of the transferee. For his services in the reorganization and his agreement to manage

taxpayer it was agreed, *before any stock was issued*, the sole stockholder of the old company would receive 1000 shares of taxpayer's stock to be issued and this agreement was duly performed. (R. 29) (See end page 5 of Government's brief)

Affiliated with this point is the claim in note 3 on page 9 of its brief that "In fact control within the statutory definition was not even in the participating creditors". (What it means here is qua creditors.). The statement of facts on page 5 of the government's brief shows all petitioner's stock, except the 1000 common shares (out of 7500 shares) issued to the sole stockholder of the transferor was issued to creditors of the insolvent transferor. More than 80 per cent thereof was issued to these creditors.

True it is the largest bondholder of the transferor (who owned more than one third of its bonds) received most of its common stock for new money but the unalterable fact is that the creditors of the transferor and its sole stockholder were in control of the property before and after the transfer. The bondholders alone received over 80 per cent of the stock of the transferee. No new people came in. Not a single share was issued to any person who did not own securities in the transferor. The words "the same persons or *any of them*" are very broad and the government's contention that the test is whether 50 per cent new people come in has been upheld. *Monarch Electric & Wire Co. v. Commissioner*, 38 F. (2d) 417 (C. C. A. 7th); *Fairbanks Court v. Commissioner*, 84 F. (2d) 17; cer. den. 299 U. S. 582. The Statute does not require that control be received in exchange for the property transferred. If it did it could be easily avoided.

The Government's Contention That There Can Be No Reorganization Under Sec. 112 i (1) of the 1932 Act Unless the Stock of the Transferor is in Substance Exchanged for Stock of the Transferee Cannot Be Upheld Without Altering the Plain Words of the Statute.

The 1932 Statute is quoted on page 13 of petitioner's reply brief. It does not say what the above heading says, yet the Government in effect asks the court to say it does by contending that the interest transferred must be solely a shareholder interest. Congress surely knew how to say that, if it had wanted to. We submit if the Treasury had asked it to so legislate it would have refused.

Even in 1934 when it changed this section (and its Committees stated they had changed it) it was only changed to require the transferee to issue voting stock for the assets of the transferor. This provision was not retroactive. It was not changed to require the transferee to issue such voting stock in exchange for stock of the transferor. Yet that is clearly the substantial effect of the change in it the Government asks this court to make by judicial decision. That is a power the Constitution grants to Congress alone.

No gain or loss is recognized under Section 112 (b)(5) where bonds are transferred to a corporation for its stock if immediately after the exchange the persons who transfer the bonds are in control of the transferee. *Leckie*, 37 B. T. A. 252.

The Government, referring to this on page 29 of its Southwest Consolidated brief correctly indicates the same legislative purpose underlies all these non-recognition provisions.

> "It is the same legislative purpose which, we believe, underlies the decisions that have developed judicially the rule requiring a continuity of interest."

We agree that the same purpose runs through all these non-recognition provisions and emphasize the importance of this point (see also section 112 (b)(3) quoted on page 30

of taxpayer's main brief) for we submit that the concession by the Government that the same purpose underlies them all coupled with the undoubted fact that a transfer of bonds to a corporation for not less than 80 per cent of its stock remains within the non-recognition provisions, destroys its whole argument in these cases—for if one may transfer bonds for stock and be within them, then surely one may transfer the economic interest the bonds represent and be within the policy underlying this legislation. It shows it is not the interest transferred but the interest at the conclusion of the transaction that decides the continuity of interest question.

Surely, if Congress had intended that stock alone or only the interest represented by stock of the transferor might be exchanged for stock of the transferee, it would have said so. No one in right mind would intend that and say "stocks or securities" might be exchanged as in sec. 112 (b)(3) or "property" as in sec. 112 (b)(5).

So far as we can discover administrative rulings have always been uniform that an exchange of bonds for stock of a corporation is a non taxable transaction if the persons making the exchange control the transferee immediately thereafter. *Leckie*, 37 B. T. A. 252.

Also all decisions agree that there need not be a continuity of the same interest. In *Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378, the court said: (page 386) "True it is that the relationship of the taxpayer to the assets conveyed was substantially changed, but this is not inhibited by the statute". See also *Hartzell*, 40 B. T. A. 492. This is obvious from the fact that the statute says a recapitalization is a reorganization and in a recapitalization bonds may be changed to stock. (See Committee report quoted on page 32 of taxpayer's main brief.) *Cf. Hoagland Co.* v. *Helvering*, 121 F. (2d) 962 where bonds were replaced by stock. Preferred stock may be changed for common. *Muchnic*, 29 B. T. A. 163. In these cases the same interest is not continued. This negatives the Government's contention that the change of bonds into stock destroys the continuity of interest.

On page 24 of its brief in the *Southwest Consolidated* case the Government states: "It may be assumed that clause E means no more than it says". Although taxpayer here says the same about every clause in the Statute, it will undoubtedly heartily concur in this statement as to Clause E. (Clause D in 1932 Act, involved in this case) which says a reorganization is a "mere change in * * * place of organization, however effected". (See pages 14, 19, 20 of taxpayer's reply brief.) The new corporation organized under the California law possessed the same assets as the old one organized under the Nevada law (The El Mirador Hotel) and the sole stockholder and bondholders of the Nevada company were interested in the new company. The words "however effected" embrace the way in which the change was effected in the case at bar and any other way.

CONCLUSION.

Corporations emerging from insolvency and their security holders have a hard enough struggle to survive without having the additional burden of an unjust result saddled upon them.

The decision of the Board of Tax Appeals should be affirmed.

All of which is respectfully submitted.

THOMAS J. HERBERT,
Attorney General of Ohio.

APPENDIX.

The purpose of this appendix is to explain Point II in more detail to the Court, the effect under the existing excess-profits tax law of 1940 of narrowing the definition of reorganization by judicial construction.

Section 718(a)(2) of the Code defines invested capital as follows:

> "Property (other than money) previously paid in (regardless of the time paid in) for stock, * * *. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange * * *."

The basis of property on sale or exchange is cost (Section 113(a)) unless it is within one of the exceptions in Section 113 such as the reorganization exceptions.

During the boom period from 1923 to early in 1929 thousands of companies were reorganized. In nearly all these cases the property was worth more at date of reorganization than at any other time. Consider alone the vast utility systems formed during this period and the then market value of their stock. If it is *now* decided in the cases at bar that the rules defining a reorganization, which existed during that period, were erroneous and that no reorganization took place because the stock of the transferee was acquired in exchange for bonds, these companies are not within the reorganization exception which limits the basis of property to that of the predecessor corporation, but cost becomes the basis. The cost is the fair market value of the stock issued for the property at the time of its issuance. Consequently, all these taxpayer companies organized during these boom years can now use these inflated values as the basis of their invested capital upon which present excess profits taxes largely depend.

These inflated values also become the basis for depreciation and for computing profit on subsequent sale of the property or increase loss on subsequent sale or exchange. Also the basis to the security holder is stepped up.

Effect of Rule of Le Tulle v. Scofield.

From 1923 to shortly before the time of the decision in *LeTulle* v. *Scofield*, transactions, such as there involved, were considered to be reorganizations. For the foregoing reasons the decision that they were not reorganizations is likely to prove more costly than advantageous to the revenue. This further indicates the rule in *Le Tulle* v. *Scofield* should not be extended.

Illustration: A building and land cost a corporation $500,000 in 1913. In January, 1929, its fair market value was $3,000,000. At that time these assets were acquired by a new corporation in what was then considered a nontaxable reorganization ("acquisition by one corporation of substantially all the properties of another"). They were acquired for bonds issued by the new corporation having a fair market value of $3,000,000 at the time of acquisition. In 1940 it appeared from the judicial decision in the *Le Tulle* case the 1929 acquisition by the new company was not in a reorganization. The result is instead of $500,000, the basis to the acquiring corporation becomes $3,000,000 for invested capital credit under the excess profits tax law of 1940, for depreciation and computation of profit or loss on subsequent sale or exchange.

This is because, not being a reorganization, the basis is not restricted to that of the preceding owner, but becomes cost to the new company, which is the fair market value of the bonds issued for the property of $3,000,000. The acquisition having been considered a reorganization in 1929, those receiving the bonds were not taxed thereon. The limitation on the right to tax them on the profit ran in 1932.

As a result they take in the aggregate a basis of $3,000,000 for computing profit and loss.

This example indicates what follows from overturning concepts of reorganization which prevailed in years outlawed as to most taxpayers.

In *American Light & Traction Company*, 41 B. T. A. 1121, the Commissioner lost a deficiency of $859,884.77 because his holding in that case that there was a reorganization in 1928 appeared erroneous under the rule of *Le Tulle* v. *Scofield* and the basis was accordingly stepped up. See 41 B. T. A. 1121, 1124.

SUPREME COURT OF THE UNITED STATES.

No. 503.—October Term, 1941.

Palm Springs Holding Corporation, Petitioner, *vs.* Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

[February 2, 1942.]

Mr. Justice Douglas delivered the opinion of the Court.

This case is a companion case to *Helvering* v. *Alabama Asphaltic Limestone Co.*, No. 328, decided this day. This, too, was an insolvency reorganization, though a different procedure was employed to consummate it. The old corporation had outstanding about $300,000 face amount of first mortgage bonds, secured by a lien on its realty. The property, which was an hotel, was leased to an operating company. In 1931, as a result of transactions not relevant here, one Pinney became the sole stockholder of the old corporation and of the operating company. The furniture and fixtures in the hotel were owned by the operating company. They were covered by a chattel mortgage which, together with the lease on the hotel, were assigned and pledged as part of the security for the bond issue. In 1931 both companies were in financial difficulties and insolvent, at least in the equity sense. A bondholders' committee was formed which received deposits of more than half of the face amount of the bonds. Petitioner was formed in 1932. Pursuant to the plan of reorganization six shares of petitioner's preferred stock and four shares of its common stock were issued to assenting bondholders for each $1000 bond. In addition all of petitioner's remaining common stock was issued to one Lacoe in return for his agreement to pay the costs of incorporating petitioner up to $1000 and for his agreement to lend money to petitioner. Before the actual issuance of any of the shares, Lacoe agreed to transfer 1,000 shares of the common stock to Pinney, the sole stockholder of the two companies, for his services in the reorganization and as an inducement to him to continue as manager of the hotel. None of the stock of petitioner, however, was issued to any stockholder or former stockholder of either of

the companies for any rights any of them had as stockholders. In May, 1932, the indenture trustee declared the principal of the bonds due and payable. Pursuant to the terms of the indenture, the trustee sold all of the properties of the old corporation, including the lease and chattel mortgage, to petitioner, the highest bidder. The bid price was $61,800. It was satisfied by the payment of about $18,700 in cash and by the delivery to the trustee of bonds of a face amount of $292,000 for the balance. Foreclosure proceedings against the old corporation and the operating company were then instituted. At the foreclosure sale the furniture and fixtures, comprising all of the property of the operating company, were bought in by petitioner.

The Commissioner, in determining a deficiency in petitioner's income and excess profits tax for the fiscal year ended May 31, 1936, disallowed depreciation deductions on both the realty and personal property on the basis of cost to the old corporation and operating company.[1] He used as the basis the cost of the assets to petitioner plus the cost of additions. The Board of Tax Appeals sustained the Commissioner's determination with respect to the personal property but rejected it with respect to the realty. The Circuit Court of Appeals sustained the Commissioner on both points. 119 F. 2d 846.

Though the petition for certiorari raised the question, petitioner now concedes that the acquisition of the furniture and fixtures

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[1] Sec. 113(a)(7) of the 1932 Act (47 Stat. 169, 198) provides in part:

"(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

. . . . . .

"(7) *Transfers to corporation where control of property remains in same persons.*—If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made."

That provision is applicable here. See, § 114(a), § 113(b), § 113(a)(12) of the Revenue Act of 1934, 48 Stat. 680. The property here involved was acquired after February 28, 1913, in a taxable year prior to January 1, 1934, as required by § 113(a)(12). Respondent argues that this transaction was not a "reorganization" within the meaning of § 113(a)(7). And he points out that "control" was not in the participating creditors since the majority of the new common stock had been distributed, for a consideration other than an exchange of bonds, to Lacoe and Pinney. But he does not contend that assuming there was a "reorganization", an "interest" in the property of 50 per cent or more did not remain in the same persons (the bondholders) immediately after the transfer.

from the operating company was not a "reorganization" within the meaning of § 112(i)(1)(A) of the Revenue Act of 1932. So we do not reach that issue. As respects the assets acquired from the old corporation, we think there was a "reorganization" within the meaning of § 112(i)(1)(A) of the 1932 Act. That provision is the same in the 1932 Act as in the 1928 Act which was involved in *Helvering* v. *Alabama Asphaltic Limestone Co., supra.* That case is determinative of this controversy. The transaction fits the literal language of the statute. The new corporation acquired the assets directly at the trustee's and the foreclosure sales. The legal procedure employed by the creditors is not material. The critical facts are that the old corporation was insolvent and that its creditors took steps to obtain effective command over its property. For the reasons stated in *Helvering* v. *Alabama Asphaltic Limestone Co., supra,* the creditors at that time acquired the equivalent of the proprietary interest of the old equity owner. Accordingly, the continuity of interest test is satisfied.

Reversed.

Mr. Justice ROBERTS did not participate in the consideration or decision of this case.

A true copy.

Test:

Clerk, Supreme Court, U. S.